Asset Allocation

What is Asset Class

Avoid investment pitfalls with better asset allocation
When preparing for exams, students cram as many chapters as possible because they never know from which chapters questions might come. However, when it comes to investments, this approach is forgotten. Instead, driven by emotions and feelings, investors and traders tend to concentrate all their funds into one asset class, be it stocks, bank fixed deposits or gold. It's like putting all the eggs in one basket! This can significantly up the risk of investment loss. This is why it's important to important to understand what an asset class is and how asset allocation works.

Understanding the ABCs of an asset class
In the world of finance, an asset class refers to a group of financial instruments that have similar traits. For instance, bank deposits and debt mutual funds fall under the debt/fixed income asset class because they share similar financial structures and are subject to the same tax laws. Likewise, equity mutual funds, unit-linked insurance plans (ULIPs), and stocks belong to the equity/stock asset class due to their common characteristics and financial features.

Let's delve into the primary asset classes/categories to enhance your understanding:
Stocks or Equities: Imagine you own a piece of a company—that's what equities are all about! Investors have an opportunity of benefiting from the equities hoping the share prices will go up or they will receive dividends. The major stocks/equities asset class is usually categorised into small-cap, mid-cap and large-cap stocks. Small-cap stocks tend to be more volatile and carry higher risk compared to large-cap stocks. While small-cap stocks may have the potential of offering higher returns, they are also more susceptible to market downturns.

Bonds or other fixed income investments: As the name suggests, fixed income investments are the ones that guarantee return rates at maturity, this is unlike many other types of investments. It's important to note that many fixed income investments offer a fixed return, not all do. Fixed income investments are ideal for low-risk investors as they are perceived

as less risky compared to other asset classes. government bonds, company debentures, and corporate bonds—all part of this group.

Cash or cash equivalents: Gold is one of the coveted assets as it is highly liquid and inherently scarce. This makes gold a valuable investment. Within an investment portfolio, gold plays multiple roles: it provides long-term returns, acts as a diversifier to mitigate losses during market downturns and can be easily sold. Investors can invest in physical gold in the form of bars, coins or jewellery. Although this offers direct ownership of the precious metal, it comes with storage and security concerns. Or, they can go for sovereign gold bond schemes—kind of like buying gold, but without the hassle of storing it.

Real estate and other physical assets: Real estate and other physical investments are considered a different kind of investments. They are valued because they offer a hedge against inflation that cannot be provided by financial instruments. These real estate assets such as residential properties, commercial buildings and mixed-use buildings are called real assets as they are physically available, rain or shine.

What is Asset Allocation

Smart investing: A Guide To Optimal Asset Allocation

Asset allocation is an investment strategy of not risking all your money in one investment. In other words, investors spread the risk by dividing their portfolios among asset categories such as stocks, equities, bonds, real estate, sovereign gold and cash. This is done because different assets perform differently under various market conditions. Asset allocation allows you to mitigate the effect of poor performance of one class and, thereby, protecting the overall financial health of your portfolio.

However, you must understand that asset allocation is highly personalised and dynamic. There is no single formula or method to determine optimal asset allocation. It varies from individual to individual. That means individual factors such as age, current life stage, risk tolerance, financial goals and market conditions come into play when making decisions regarding asset allocation. This also implies that asset allocation is not a one-time strategy. It needs to be reviewed and aligned with changing financial goals, risk tolerance and other factors.

Goal of Asset allocation

Goals of Asset Allocation: Balancing Risks And Rewards
The whole idea behind having an asset allocation strategy is to achieve a balanced investment portfolio. It aims to optimise risks and rewards based on investors' objectives and risk tolerance. Having an asset allocation strategy ensures that you are neither leaning too far into risky investments which offer high potential gains but also significant losses nor staying too conservative with safer investments that carry lower risk but potentially modest or low returns. The following are some of the common goals of asset allocation:

- Mitigate effects of market fluctuations: The fluctuation in the financial market is the primary reason investors experience both gains and losses when asset allocation is not optimised. By spreading the risk across different asset classes, asset allocation reduces the impact of market fluctuations on the overall portfolio. When one asset class underperforms, others may perform better. This helps manage the overall risk of the portfolio thereby, reducing the likelihood of significant losses during market downturns.
- Minimise losses and maximise gain: At the end of the day, all investors want is to reduce losses and maximise gains. By reducing losses, the potential for increasing gains is automatically increased in the long run. If one asset is losing money, the others can make up for the losses. Reviewing your investment portfolio from time to time can help to maintain the desired asset allocation.
- Manage risk tolerance: Every investor has a different risk appetite. Not everyone is comfortable with big ups and downs in their investments. Asset allocation helps them to choose a mix of investments that aligns with their individual risk tolerance.
- Behavioural discipline: Emotions can significantly affect investment decisions. Asset allocation provides a structured framework for making investment decisions and thereby helps investors have a long-term and well-thought-out strategy in place. If the portfolio is well-diversified, investors are less likely to make emotional decisions.

Why Does Asset Allocation Work & Importance

Understanding why strategic asset allocation works

By now you know what asset allocation is and how it works. But often investors, especially those who are new to the markets, wonder why asset allocation works. Well, it works because the diversification and risk-return tradeoff are fundamental to strategic asset allocation. By spreading investments across different asset classes investors are not only managing risks but also aligning investments with their risk tolerance, investment timeframe and financial goals.

Using strategic asset allocation to safeguard investments

Often higher-risk assets offer higher returns over the long term but come with greater volatility. On the other hand, lower-risk assets provide stability and income but offer lower returns. Strategic asset allocation based on risk preferences can help balance the desire for returns with the need to manage risk exposure.

For instance, young investors have a long investment timeframe, they can afford to take more risks as they have time to recover from potential market downturns. On the other hand, those approaching retirement look for investments that provide more stability and reduce the impact of market volatility on the portfolio.

Adjusting asset allocation over time to reflect changing financial goals, risk tolerance and investment timeframe is likely to help investors to meet their financial needs without significant exposure to market fluctuations.

Why asset allocation matters in achieving stability and growth

Asset allocation is important for achieving stability as well as growth in investments. This strategic approach helps to stabilise portfolio performance during market fluctuations while positioning it for long-term growth. By aligning investments with an individual investor's risk tolerance and financial goals, asset allocation ensures a balanced approach to wealth management.

Advantage & Disadvantage of Asset Allocation

Balancing Risks and Rewards: The Pros and Cons of Asset Allocation
Pros:

- Potential for Higher Returns: Diversifying across different asset classes through asset allocation may offer the opportunity for maximising profits.
- Mitigate Losses: Any gains in the well-performing asset class may mitigate the losses in the bad-performing ones.
- Dynamic Asset Allocation: Good portfolio managers try dynamic asset allocation strategies to achieve returns higher than the average market returns.
- Beat the Market: Through effective portfolio mix management, asset allocation strategies will help one to outperform the market.

Cons:

- Getting Asset Allocation Right: The inherent nature of the financial markets is change. This makes it difficult to achieve proper asset allocation.
- No Guarantee of Success: It needs to be noted that merely following asset allocation does not guarantee success in investment portfolios. Investors need to be strategic about which assets to buy and when.
- Timing is Important: Effective dynamic asset allocation depends on entering the right asset at the right time and exiting the wrong asset at the right time.