Choose wisely.

An Investor Education Initiative

PRUDENT INVESTING

Introduction:

If you show good and careful judgment while handling all types of matters, you may be described as **Prudent**. Similarly, a wise and well-thought-through decision or action may be called **Prudent**.

It is very important for an investor to be prudent when it comes to investing, as being prudent is one the most important factor which will reap investor good returns.

3 Important qualities of Prudent Investors

1. **They follow Asset Allocation Strategies** - Investors who follow asset allocation based on their risk profile and investment time horizon, tend to be successful investors.

2. **The Ability to Differentiate Rewards from Risks** - Prudent investors know how to differentiate risk from reward. When risk outweighs returns, they reject that investment decision.

3. **They are disciplined** - This is a must for an investor to be successful. Once invested, stay committed to achieve your goal and do not get tempted by market fluctuations. Starting SIP investments based on goals and asset rebalancing are the ideal examples for discipline.

1. Asset Allocation

What is Asset Allocation?

An investment strategy that aims to balance risk and reward by apportioning portfolio's assets according to an individual's goals, risk tolerance and investment horizon.

Asset allocation is the process of developing a customized, diversified investment portfolio by strategically mixing different asset classes in varying proportions.

Asset allocation offers investors double advantage:

- Benefit from changing market cycles
- Reduction in overall portfolio risk by offering a higher degree of diversification

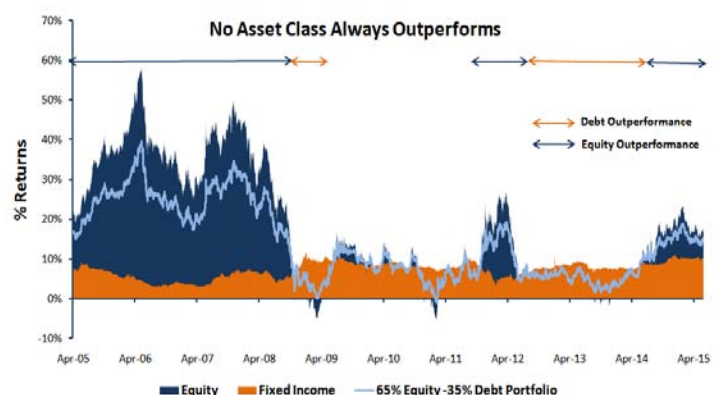
Asset allocation therefore aims to reduce the “ups and downs” associated with investing and makes it easier to stick with investors' long term investment objectives and avoid market timing. Ultimately, the objective of a good asset allocation plan is to develop an investment portfolio that will help you reach your financial objectives with the degree of risk you find comfortable.

Why Asset Allocation is so important?

Historically, the returns of the three major asset categories (Equity, Debt and Gold) have not moved up and down at the same time. Market conditions that cause one asset category to do well often cause another asset category to have average or poor returns.

By investing in more than one asset category, you may reduce the risk that you'll lose money and your portfolio's overall investment returns may have a smoother ride. If one asset category's investment return falls, you may be in a position to counteract your losses in that asset category with better investment returns opportunities in another asset category.

A well-diversified plan will not outperform the top asset class in any given year, but over time it maybe one of the most effective ways to realize your long-term goals.



Past Performance may or may not sustain in future. The above graph depicts 3 year CAGR rolling returns starting from 1st April 2005 to 31st May 2015. Source: Bloomberg

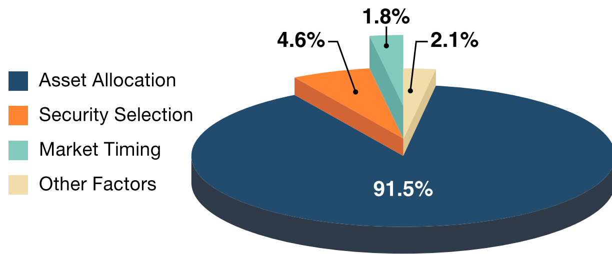
The above chart shows that no asset class (Equity or Debt) out-performs consistently, however a balanced portfolio gives investors favourable returns.

Asset Allocation Strategy drives Investment Returns

Investors are often surprised to learn that a significant percentage of the volatility of investment performance is driven by asset allocation decisions - hence asset allocation is the key for long term wealth.

Investors focus on factors like market timing and security selection instead of asset allocation which yields the maximum results as shown by the chart below:

Drivers of investment results



Source: Financial Analyst Journal, 1986

2. Balance Risk and Reward

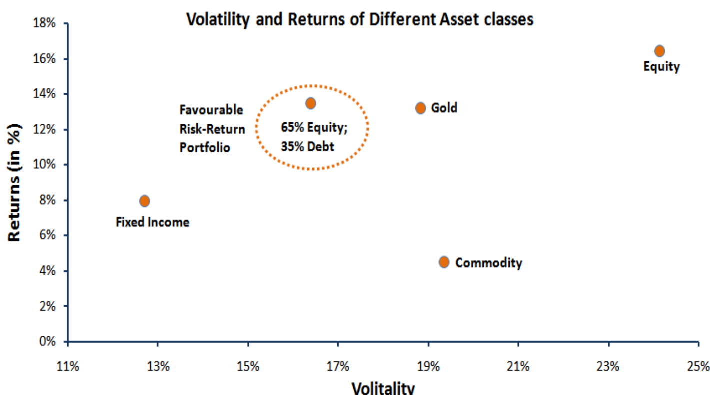
When it comes to investing, risk and reward are inextricably entwined. You've probably heard the phrase "no pain, no gain" – those words come close to summing up the relationship between risk and reward. Don't let anyone tell you otherwise

The trade off which an investor faces between risk and return while considering investment decisions is called the risk return trade off. It is based on the principle that potential return rises with an increase in risk. Low levels of uncertainty (low-risk) are associated with low potential returns, whereas high levels of uncertainty (high-risk) are associated with high potential returns.

Because of the risk-return trade off, you must be aware of your personal risk tolerance when choosing investments for your portfolio.

Benjamin Graham and David Dodd, founders of value investing, coined the term **"Margin of Safety"**. The central thesis of value investing philosophy is preservation of capital and it's the first rule of investing. The margin of safety protects the investor from both poor decisions and downturns in the market.

The graph below shows the historical returns and volatility of several asset classes.



Past Performance may or may not sustain in future. Volatility is annualized Standard deviation and Returns are in CAGR terms. The period of the same is 1st April 2002 to 31st May, 2015. Portfolio of Equity is CNX Nifty, Gold is Gold in INR terms, Fixed Income is I-Sec Composite Index and Commodity is RICI Commodity Index. Source: Bloomberg, 31st May 2015

3. Disciplined Investing:

Rebalancing (Powered by Value Research www.valueresearchonline.com)

As time goes by, equity and fixed income gain at different rates, thus disturbing the desired asset allocation. Shifting money between the two to restore that allocation is called **Asset Rebalancing**. Asset Rebalancing must be the most useful and yet the most ignored of the ideas in the world of investing.

The way to rebalance your portfolio is to decide that a certain percentage of your investments should be in fixed income and the rest in equity.

Asset Rebalancing means that instead of seeing the equity-vs-fixed income question as a black-vs-white binary choice, you should be seeing it as a shade of grey. Once every year or so, you could 'rebalance' your portfolio. What this means is that if the actual balance has veered away from your desired one, you should shift money from one to the other in order to attain that percentage again.

Rebalancing makes a difference

The Scenario

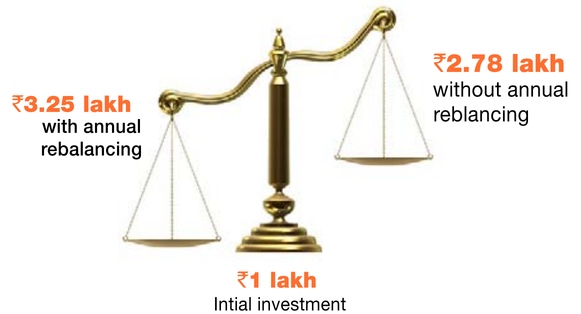
An investor invests ₹1 lakh on January 01, 2005. He puts half of his investment in equity and the other half debt. So he starts off with an equity:debt allocation of 50:50.

For the sake of simplicity, we did not look at any annual additions to the portfolio. We just stuck with the initial amount.

For equity returns, we looked at the Sensex. For debt, we looked at the one-year fixed deposit rates.
We then looked at the portfolio on January 01, 2015.

Where does he win ?

If he maintained his equity:debt allocation of 50:50 by opting for annual rebalancing, we would end up with ₹3.25 lakh.
If he choose to ignore rebalancing and just left his portfolio untouched, his investment would be worth ₹2.78 lakh.



Some readers would have seen the fly in the ointment, or rather, two flies. One is the amount of monitoring or work required; and two, the tax implications. Both are easily taken care of by not doing all this yourself and using a Balanced fund instead. Balanced funds are the most underappreciated idea in mutual fund investing. **Balanced funds do all this automatically without building of any tax liability. Much more importantly, when the market goes down, balanced funds fall less. Over the last five years, through the huge upheaval of the equity markets, the average equity-oriented balanced fund has given better returns than all the diversified fund categories.**
Source: www.valueresearchonline.com

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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