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Investment Strategies

24 January, 2020

Agenda

- Diversification
- Asset Allocation
- Active Investment Strategies
- Rebalancing & Review

Diversification

- Expected return from Individual securities is associated with some degree of risk
- Most investors cannot tolerate short-term fluctuations in their securities
- Diversification is a risk-management technique that mixes a wide variety of investments within a portfolio in order to minimize the impact that any one security will have on the overall performance of the portfolio.
- Effect of diversification is to lower the risk of the portfolio

Benefits of Diversification

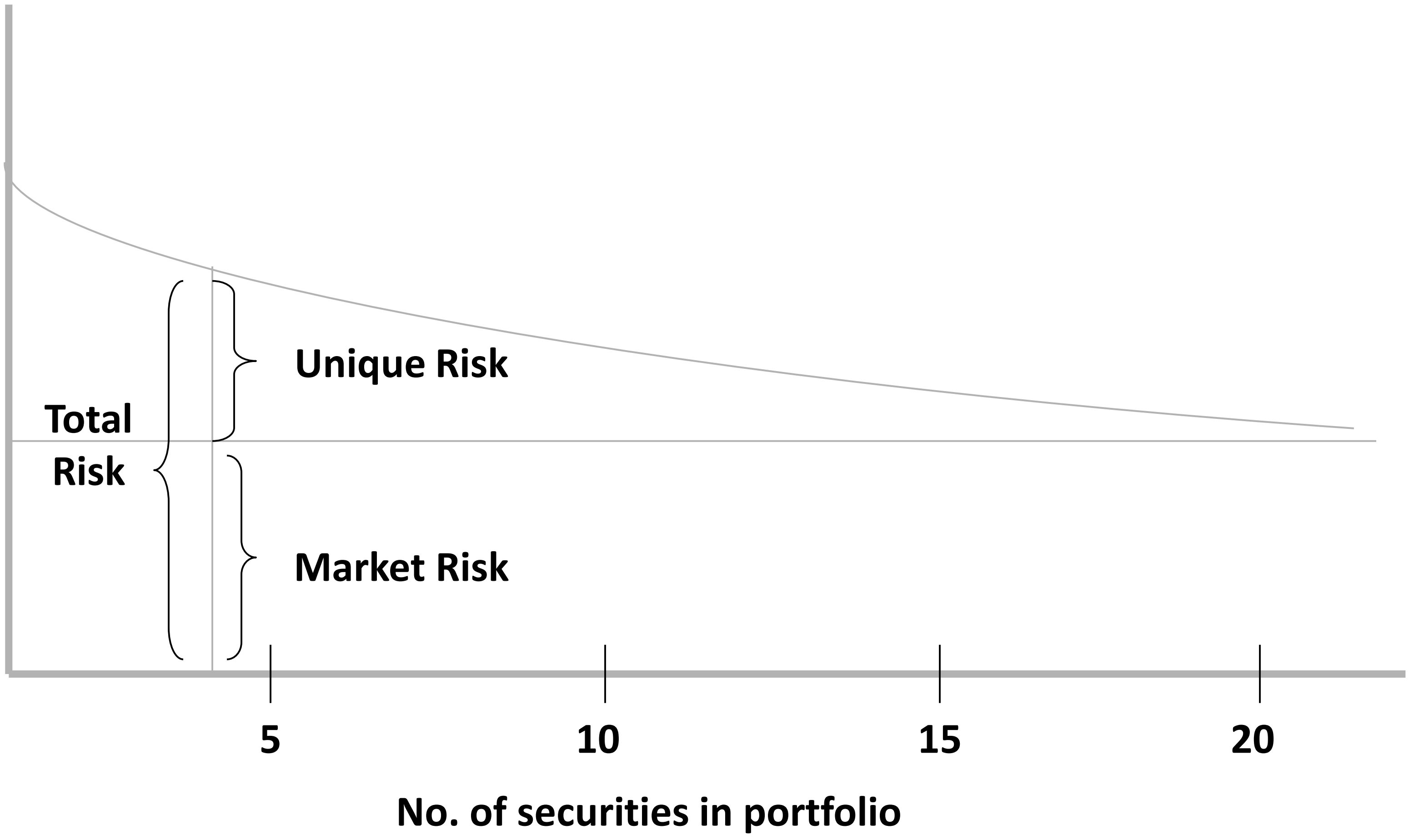
- Portfolio Risk = Market Risk (systematic) + Unique Risk(unsystematic) of portfolio
- Market Risk of a portfolio = weighted arithmetic average of the market risk of the individual securities constituting the portfolio

  e.g., if a certain amount is invested in three stocks A, B & C having Betas of 1.2, 0.9 & 1.3 in the proportion 0.5, 0.3 & 0.2 respectively, the market risk of the portfolio will be:

  $$0.5\ (1.2) + 0.3\ (0.9) + 0.2\ (1.3) = 1.13$$

- Unique Risk of a portfolio, however, behaves differently. Unique Risk tends to decline as the portfolio becomes more diversified.
- In a diversified portfolio, unique risks of different securities tend to offset each other. Hence, overall unique risk of the portfolio diminishes, and rather rapidly.
- Diversification helps an investor in eliminating (or diversifying away) unique risk.

Diversification and Risk



Levels of Diversification

- Security Level
  - Invest in more than one stock, say a combination of a few blue chip and a few aggressive stocks
- Industry Level
  - Ensure that the stocks selected are spread across various industries / sectors
- Asset Level
  - Diversify across asset classes, e.g., stocks, mutual funds, bonds, money market, bank deposits (this approach is known as Asset Allocation)

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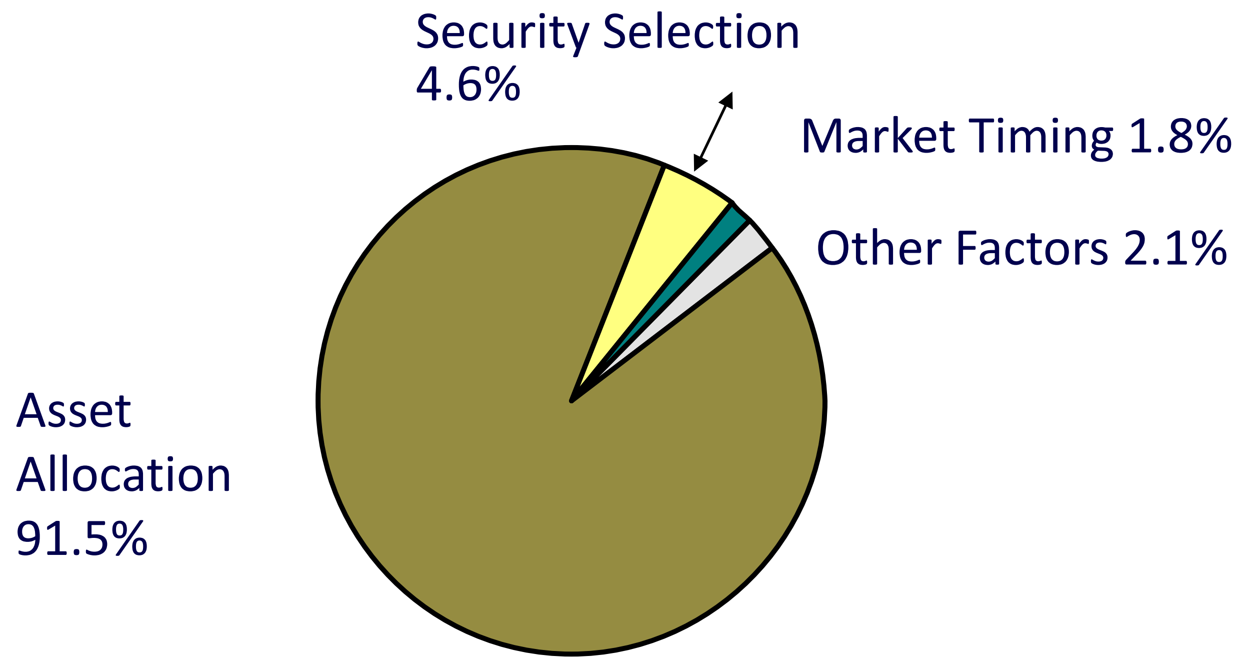
What is Asset Allocation?

Asset allocation refers to the strategy of dividing your total investment portfolio among various asset classes, such as stocks, bonds and money market securities. Essentially, asset allocation is an organized and effective method of diversification

Investments : Key Determinants

- The most important determinant of portfolio return is asset allocation .



Source: Brinson, Singer & Beebower

Asset allocation

Asset Allocation encompasses the following:

- Selection of the asset classes
- Proper blending of these asset classes in a portfolio
- Managing the asset mix over time.

Asset Allocation Principles

- Risk and return are related
- Risk depends on the length of time one holds the investment
- Rupee Cost Averaging can reduce the risks of investing
- Risks that an investor can take depends on the investor's capacity to take risks and his attitude to take risks.

Asset Allocation drivers

Asset allocation must take into account 2 factors:

- **Time horizon:** the number of years you have to invest

- **Risk tolerance:** your **ability** or **willingness** to endure short-term declines in the value of your investments as you pursue your long-term investment goal

Strategic Asset Allocation

- Strategic asset allocation is a method that establishes and adheres to what is called a 'base policy mix'. This is a proportional mix of assets based on expected rates of return for each asset class
- E.g. If stocks have historically returned 10% per annum and bonds have returned 5% per annum, a mix of 50% stocks and 50% bonds would be expected to return 7.5% per year

Tactical Asset Allocation

- In the short term, the investor may occasionally engage in tactical deviations from the mix in order to capitalize on unusual or exceptional investment opportunities
- This flexibility adds a component of market timing to the portfolio, allowing investors to participate in economic conditions that are more favourable for the performance of one asset class than for others

Tactical Asset Allocation

- Tactical asset allocation can be described as a moderately active strategy, since the overall strategic asset mix is returned to when desired short-term profits are achieved
- This demands some discipline from the investor or portfolio manager, as he or she must first be able to recognize when short-term opportunities have run their course, and then rebalance the portfolio to the long-term asset position

Dynamic Asset Allocation

- Dynamic asset allocation is when the mix of assets is constantly adjusted as markets rise and fall and the economy strengthens and weakens
- E.g. In a dynamic portfolio, if the stock market is showing weakness, stocks are sold in anticipation of further decreases in stock values, and if the market is strong, stocks are purchased in anticipation of continued market gains

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Which Asset Allocation style is best ?

- Asset allocation can be an active process in varying degrees or strictly passive in nature
- Choice of a precise asset allocation strategy or a combination of different strategies depends on one’s goals, age and risk tolerance
- These are only general guidelines on how investors may use asset allocation as a part of their core strategies
- Allocation approaches involving anticipating and reacting to market movements require a great deal of expertise and talent in using particular tools for timing these movements.
- Accurately timing the market is next to impossible, so make sure your strategy isn't too vulnerable to unforeseeable errors

Risk Profile of Investor

Risk profiling is a well-established scientific and robust way of profiling risk among investors. Research has established clear relationships between demographic attributes of investors and their investment risk appetite.

- **Conservative :** This profile is suitable for investors who prefer to preserve capital and do not intend to taking any exposure to high risk investments.
- **Moderate:** This profile is suitable for investors who are willing to take an exposure of 30% to 50% in higher risk investments like equity related products.
- **Aggressive :** This profile is suitable for aggressive investors who are willing to invest major part of their portfolio in equity related products and clearly are well informed about the potential downside that could arise in case of a sharp fall in the markets.

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Active Investment Strategies

- Market Timing
- Sector Rotation
- Security selection
- Use of a specialized concept, Investment style like value style & Growth Style

Growth Style

Growth Investing focus on companies that will experience faster than average growth as measured by revenues, earnings or cash flow. Growth oriented companies more likely to reinvest profits in expansion projects or acquisitions, rather than use them to pay out as dividends to shareholders.

- Growth Investing requires a higher tolerance of risk as well as a longer time horizon. Growth Investing do better than overall market when stocks prices in general are rising, while underperforming the market as stock prices fall.

Value Style

The goal of value investing is to find proverbial diamonds in the rough; that is, companies whose stock prices don't necessarily reflect their fundamental worth.

Such securities may be stock in public companies that trade at discounts to book value or tangible book value, have high dividend yield, have low price to earning multiples or have low price to book ratio

Value Investing focus on perceived safety than growth, often investing in mature companies that are primarily using their earnings to pay dividends.

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Rebalancing

- Portfolio rebalancing is the action of bringing a portfolio of Investments that have deviated from targeted asset allocation back into its original allocation.
- if an investor's investment strategy or tolerance for risk has changed, he or she can use rebalancing to readjust the weightings of each security or asset class in the portfolio to fulfill a newly devised asset allocation

- ***Rebalancing will help you stick to your investing plan regardless of what the market does.***

Basic policies applicable in Rebalancing

Periodic/ Calendar rebalancing of the portfolio is indicative of the frequency of rebalancing. This could be quarterly, half yearly or any other period. :

- **Buy & Hold** : Here the policies are essentially that of buy and hold, ignoring the market value of the assets.
- **Constant Mix policy** : This involves maintaining the mix of asset allocation of various asset classes in accordance to what is its target asset allocation.
- **Portfolio Insurance policy :** In this rebalancing policy, a floor level is decided then asset allocation is structured accordingly. Objective of this policy, in case risky assets value fall below floor price then whole portfolio shift to risk free asset. In case of rise in value of risky asset class then the Portfolio manager under this policy would reduce the exposure to risky asset class in order to ensure that the value remains intact.

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Financial planning review

- The financial planner should establish a client file and a system for periodic review and revision.
- The financial planner to monitor performance of investments, changes in tax laws & regulations (the general economic environment) and also evaluate new financial products for possible inclusion.
- Financial planner to regularly evaluate the plan with respect to any changes in the client's situation.

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Need for financial planning review

Regular reviews are necessary for :

- Changes in personal circumstances- Plans may need to be revised for reasons such as loss of a job, addition of a new family member and so on.

- Changes in the external environment- Changes in regulations, economic and market conditions may warrant changes in the financial plans

- Product related factors- To find out if the product recommended to the client is still applicable to his needs.

Benchmarking Performance

- Setting a performance benchmark helps track progress made towards the goal. The type of benchmarks to be used is important.
- These are important indicators for both the client and the financial planner. These indicators trigger off action that may be required
- The review process will help in identification of areas which need changes to be made.
- Situation may require focus on a particular goal to shift or abandonment of goals.
- A new plan should then be presented to the client, incorporating such changes.

Thank You

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