



Strategic approach to investments

Wealth creation is all about disciplined investment strategy.
The key is to have the right mix of assets.



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Investors are well aware that the chances of meeting their long-term investment goals are maximized not by chasing the latest market theme or the hot manager quarter by quarter, but rather by defining and sticking to appropriate strategies over an extended period. Such strategies can position a portfolio to benefit from the long-term forces in the market, enabling investors to benefit from different risk-return trade-offs as they seek higher returns than cash.

The foundation of such an approach lies in 'Asset Allocation'. Asset allocation is the process of combining different asset classes (in varying proportions) in a portfolio in the perimeter of one's goals. The asset allocation decision is an important factor in determining the return and the risk of an investment portfolio.

Every asset class has different characteristics and its response to market changes may vary. This makes due diligence indispensable while choosing assets, allocating monetary resources to each asset and determining the time for which each asset is to be held for the portfolio. An investor's financial needs, the length of his investment horizon, and

his appetite for risk influence the asset allocation decision. A wise and well researched asset allocation decision reduces the risk exposure of the portfolio while maximising returns.

The combination of asset classes in a portfolio is the single most important factor in explaining the variability of returns of an investment portfolio.

Research demonstrates that asset allocation decisions account for 91.5 percent of a portfolio's performance as demonstrated in *Chart 1*

tolerance capacity undergo changes, the composition of the portfolio also needs to change. Asset classes too grow at different rates of return, and react differently to market changes; it is therefore necessary to periodically rebalance a portfolio to maintain a target asset mix.

For example, in a particular portfolio, investments should represent 50 percent of the portfolio. But after a stock market increase, stock investments represent 75 percent of the portfolio. Now in order to reinstate the original asset allocation mix, either some of the stock investments should be sold or additional investments from an under-weighted asset category should be purchased.

ESTABLISHING AN ASSET ALLOCATION STRATEGY and rebalancing regularly to preserve that strategy will introduce more discipline into an investment plan.

Reducing Risk Through Diversification

The most important advantage of asset allocation is the reduction of risk in a portfolio through diversification. As the number of asset classes in a portfolio increases, the total risk of the portfolio decreases. Through diversification, the effect of any individual security or asset class on the performance of the portfolio can be limited.

A portfolio should be diversified at two levels: between asset categories and within asset categories. So in addition to allocating investments among stocks, bonds, cash equivalents, and possibly other asset categories, investments should be spread within each asset category. The key is to identify investments in segments of each asset category that may perform differently under different market conditions.

While rebalancing, one also needs to review the investments within each asset allocation category. If any of these investments are out of alignment with the investment goals, changes should be made to bring them back to their original allocation within the asset category.

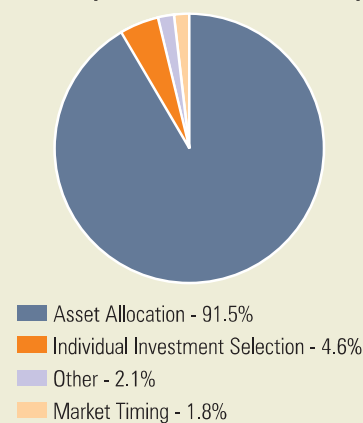
Building Optimal Portfolios

In 1952, Harry Markowitz was the first to quantify the link that exists between the risk and return of a portfolio, when he introduced the Modern Portfolio Theory. Markowitz's pioneering approach is based on a simple principle—maximising the investor's objectives as a function of the risks being run, with the latter being measured by the volatility of the assets.

The Efficient Frontier is a series of points that models the range of possible portfolios, each representing the highest returning combination of investments for a specified level of risk. Each point along the Frontier represents a combination of asset classes that can, in theory, provide the highest level of return for an individual

Chart 1

Portfolio performance is determined by:

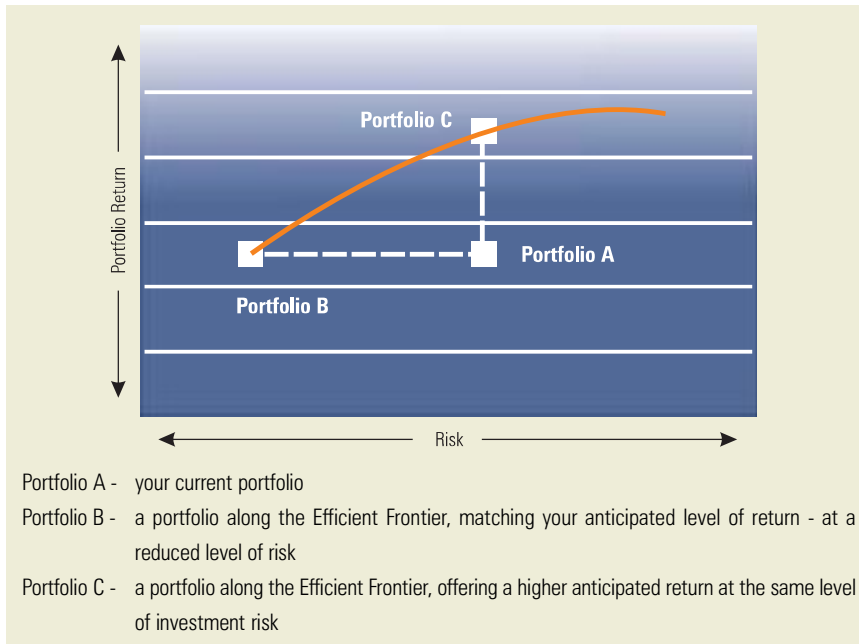


Source: A landmark study, "Determinants of Portfolio Performance", by Brinson, Hood and Beebower.

Rebalancing The Portfolio

The asset allocation decision is not a one-time decision—it is a process. As an investor's time horizon, needs and risk

Chart 2



investor’s specific risk tolerance. Similarly, it also depicts the lowest level of risk to help achieve a desired return target (Chart 2).

Sharpe ratio helps you find the best possible proportion of securities to use, in a portfolio that can also contain cash. The definition of the Sharpe Ratio is:

$$S(x) = (r_x - R_f) / \text{StdDev}(x)$$

where

x is some investment

r_x is the average annual rate of return of x

R_f is the best available rate of return of a “risk-free” security (i.e. cash)

StdDev(x) is the standard deviation of r_x

The Sharpe ratio is used to characterize how well the return of an asset compensates the investor for the risk taken. When comparing two assets each with the expected return $E[R]$ against the same benchmark with return R_f , the asset with the higher Sharpe ratio gives more return for the same risk. Investors are often advised to pick investments with higher Sharpe ratios.

The Sharpe Ratio is a direct measure of reward-to-risk. To see how it helps you in creating a portfolio, consider the diagram of the Efficient Frontier again, this time with cash drawn in.

If you take some investment like “x” and combine it with cash, the resulting portfolio will lie somewhere along the straight line joining cash with x. The result will be the portfolio with the greatest possible rate of return

The Capital Asset Pricing Model (CAPM) is an economic model for valuing stocks, securities, derivatives and/or assets by relating risk and expected return. CAPM is based on the idea that investors demand additional expected return called the risk premium if they are asked to accept additional risk. It helps us to calculate the expected investment risk and return.

CAPM model says that the expected return that investors would demand is equal to the rate on a risk-free security plus risk premium. If the expected return does not meet the required return, the investors will refuse to invest and the investment should not be undertaken.

CAPM can be calculated in the following way

$$\text{Expected Security return} = \text{Riskless return} + \text{Beta} * (\text{Expected market risk premium})$$

Beta is the overall risk in investing in large market like, the New York Stock exchange. Each company has a Beta. A company’s

Beta is that company’s risk compared to the Beta (risk) of the overall market. If the company has Beta of 3.0 then it is said to be three times more risky than the overall market. Beta measures the volatility of the security, relative to asset class.

Rewards of Asset Allocation and Rebalancing

Asset allocation and rebalancing play important roles in achieving and maintaining diversified and disciplined investment portfolios. These relatively straightforward investment strategies can provide investors with a number of potential benefits.

A diversified portfolio can experience reduced investment risk because the growth opportunity is not limited to the performance of a security, but is open to opportunities presented by a collection of securities. The performance of one laggard investment will not affect the entire portfolio.

Investing in a selection of securities spread across different asset classes builds a portfolio that may help reduce volatility in turbulent times. A well diversified portfolio can provide investors with the opportunity for growth with less portfolio volatility.

It is nearly impossible to time the performance cycles of different investment categories. Establishing an asset allocation strategy and rebalancing regularly to preserve that strategy will introduce more discipline into an investment plan.

Conclusion

Portfolio asset allocation accounts for the majority of variation in investment returns, therefore research efforts should be focused on monitoring and adjusting asset allocation rather than market timing or security selection. Effective tactical asset allocation process adds value in the longer-term by applying temporary tilts and changes of emphasis to the portfolio’s strategic asset array within agreed boundaries.