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Research Article

DYNAMIC ASSET ALLOCATION

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ABSTRACT

Asset Allocation aims to create a mix of assets in order to provide an optimal balance between expected risk and return keeping in mind a long-term investment horizon. It divides investments in to various investment options trying to get maximum returns with minimum risks. A portfolio created for this purpose is diversified, keeping in mind risk tolerance, investment objective and time horizon. This paper tries to study different asset allocation models used for different investment objectives and need for rebalancing the portfolio from time to time. An example of ICICI Prudential Balanced Advantage Fund has been taken to study the impact of Dynamic Asset allocation on the long term performance of a mutual fund.

INTRODUCTION

Wise people will always advise you, "Don't put all your eggs in one basket".This advice is very apt for the investors. It's a simple warning that if a chosen financial plan carrying all your savings flops, you lose all of your hard earned money. So, the success mantra is 'diversification'. That means adopting the strategy of holding more than one type of investment in order to reduce risks. One can diversify the stock holding by buying a combination of different stocks (small, large, international stocks) and/or bond holding by buying different types of bonds (short-term and long-term bonds, government bonds, or high- and low-quality bonds).

The strategy of diversification doesn't mean that there is no risk of invetment losses. It simply reduces the risks as in a changing economic or market conditions, there reaction is never identical. They react differently and in that case, a few may go very down, a few may remain stable and a few may gain as well. So, the results are mixed thus reducing the risk.

Normally a more risky investment (such as stocks) outperforms a less risky diversified portfolio of stocks, bonds, and cash. Still the advantage of diversification in reducing risk is preferred over increased returns.

The benefits of diversification are experienced over a short period of time. For example during 2007-2009 banking and credit crisis, investors who had portfolios composed only of stocks suffered large losses, and those who had bonds or cash in their portfolios experienced less amount of losses.

Asset Allocation

Asset allocation means distribution of investments among various investment options available to an investor (e.g., stocks and bonds).

While doing financial planning, a person is required to select assets that are compatible with the defined financial goals, assets that generate good returns at a desired level of risk. This activity is known as asset allocation. It involves division of investments between different asset classes such as equities, cash and money markets equivalents, bonds, insurance, real estate, derivatives, gold, commodities, antiques and art, international financial instruments.

Asset Allocation and Diversification

The principal reason for diversifying investments across different asset classes is to minimize the risk of a portfolio. It requires one to avoid investments whose returns tend to move too closely with each other. So if one was to invest in growth stocks, value stocks, small caps and mid caps it would mean that their returns would be highly correlated so they would virtually fall in the same asset class. However, in case of fixed income instruments there are different varieties of instruments available which would depend on the tenor, issuer, credit rating and the cash flows. It would also depend on the

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nature of the instrument, for example, convertible and non convertible, fixed rate or flexible rate, listed or unlisted, marketable and non marketable and so on.

Some of the various types of asset classes with their sub-categories are:

- Bonds. They include investment grade or junk (high yield) bonds; bonds issued by government or corporate; short term, intermediate, long term bonds; domestic, foreign, emerging markets bonds.
- Stocks. Stocks may be value or growth. They may be large cap, small cap; domestic, foreign, or emerging markets.
- Different types of Mutual Funds
- Real estate
- Foreign currency, etc.

Once an individual has identified these asset classes, he needs to know how to divide his/her investments in these asset classes. The key considerations in choosing the asset classes are the level of return and risk. Liquidity, transaction costs and ease of investment are other considerations.

Principles of Portfolio Construction

The factors that one should consider in choosing exposures to different asset classes are as follows:

***Risk Tolerance*:** The degree to which one can tolerate risk varies for different people and depends on the following:

- ***Stage in life:*** A younger person, having a safe livelihood and few dependents, has time on his/her side can take more risk while choosing a portfolio.
- ***Net Worth:*** If one owns lot of assets and has few liabilities can take more risk
- ***Experience with investments:*** If one has prior experience in investing in financial markets and one is comfortable with short term fluctuations then one can take more risks and hence more exposure to equity.

Investment Objective: Investment objective is the purpose for which the investments are being made.

Objectives could be

- A person nearing his retirement would want a regular stream of income from the investment, while preserving the capital value, and should hence choose a safer portfolio.
- If one is looking at growth along with preservation of capital, and is investing for a goal that is very important, such as saving for one's child's education, then one can take some more risk in pursuit of higher returns, but not at such a high risk that it might erode one's capital.
- If one is looking at high growth and investing for a goal that is not very important then one can afford to take more risk.

Time Horizon: The time for which one would like to hold an investment also impacts the level of risk that one can undertake. If the goal for which the investment is being made is occurring after a long time, then one can pursue higher returns by investing in a more risky portfolio as over the period of time the risk reduces

Asset Allocation Models

There are mainly four asset allocation models:

- ***Preservation of Capital Model:*** This asset allocation model is for those who want to preserve their money for near future. The major part of their portfolios includes treasury notes and commercial papers.
- ***Income Model:*** This asset allocation model is for those who demand steady income for a considerable period of time, especially those on retirements. Includes investing in real estate, government bonds, shares of companies with prolonged dividend payments, insurance policies, etc.
- ***Growth Model:*** This asset allocation model is for those who want to maximize their capital in a short time. Includes investing mainly in stocks and similar instruments. They mainly follow growth investing strategies and prefer mid and small cap stocks.
- ***Balanced Model:*** This asset allocation model is for those who want growth and income. Includes investments in fixed income instruments, real estate, stocks of all sizes (large, mid and small cap in a managed way).

Once an individual has decided on his asset allocation, the next step is which securities within those asset classes should one select, and whether one should change the allocation from time to time based on market conditions.

Portfolio Rebalancing

Portfolio rebalancing helps in keeping investments in line with one's investment strategy. The idea behind rebalancing is to reduce risks created by buildup of an inconsistent sum of money in any market sector. Portfolio rebalancing is not an attempt to time the market, but rather a timely reassessment and modification of an investor's target goals.

The primary purpose of rebalancing is to maintain a consistent risk profile. It also provides a regular plan of action. Rebalancing accomplishes the reduction of assets that performed best (or worst) and the reinvestment of those proceeds into other assets to bring the portfolio to its original balance.

Example, say one has determined that given his risk tolerance, time horizon and financial goals, his portfolio should look like:

Stocks	**60%**	**Rs.60,000**
Bonds	35%	Rs.35,000
Cash	5%	Rs.5000
Total	100%	Rs.100,000

A couple of stocks run up and the portfolio looks like:

Stocks	**66%**	**Rs.80,000**
Bonds	29%	Rs.35,000
Cash	4%	Rs.5000
Total	100%	Rs.120,000

Though the investor has moved up by Rs.20000, but he has moved away from the ideal asset allocation and possibly exposed him to more risk than is acceptable.

How to rebalance

There are three good options for doing rebalancing:

1. ***Targeted Rebalancing:*** For this option, one has to determine a range of say 5% to 10% around the target allocation for each asset class. If the markets move enough to cause one asset class to exceed the range, he has to then rebalance to bring them back in line.
2. ***Tactical Rebalancing:*** For this, one has to set broad asset class ranges and incorporate a market outlook into his decisions. For instance, he might set a range for stocks from 50% to 70% of his portfolio. If stocks seem overvalued, he would rebalance back towards the low end of the range. If they seem cheap, he would rebalance towards the high end.
3. ***Calendar Rebalancing:*** This is perhaps the easiest of all, one simply picks a time period (quarterly, annually, etc.) and rebalances his portfolio back to its original targets.

Asset Allocation Strategies

Drifting Asset Allocation

This policy states that the initial portfolio be left unaltered. It is essentially a 'buy & hold' policy. Under this policy irrespective of what happens to relative values, no rebalancing is done.

Some of the important features are:

- The value of the portfolio is linearly related to that of the stock market.
- While the portfolio value cannot fall below the value of the initial investment in bonds, its upside potential is unlimited.
- When stocks outperform bonds, the higher the initial investment in stocks, the better the performance of the buy and hold policy or vice versa.

Balanced Asset Allocation

A balanced asset allocation strategy calls for a periodic rebalancing of the portfolio to ensure that the stock-bond mix is in line with the long term 'strategic mix'. In other words, this policy calls for maintaining an exposure to stocks that is a constant proportion of portfolio value. For example, if the desired constant mix of stock and bond is say 60:40, this policy calls for rebalancing the portfolio when relative values of its components change, so that the target proportion are maintained.

Some of the important features of this strategy are:

- This strategy does not provide much downward protection and tends to do relatively poorly in up market.
- This strategy tends to do very well in flat, but fluctuating markets.

Integrated Asset Allocation Strategy

Integrated asset allocation strategy is a moderately active portfolio management strategy. It is practiced mainly by mutual funds, portfolio managers and some personal investors. Integrated asset allocation strategy is somewhat complex as there are no fixed rules, and requires good knowledge, frequent investment preference changes and good analysis tools for proper implementation. This strategy gives nearly equal importance to future portfolio returns and portfolio risk tolerance.

Investors following integrated portfolio management strategy may or may not have investing preferences. Often they choose to invest a fixed portion of their capital in high profit and /or low risk investments and then adjusting the other portion according to market and product performances.

Traditional Asset Allocation / Fixed Asset Allocation

The traditional approach to asset allocation involves setting fixed, or static, allocations of one's portfolio between different asset classes or investment types. Traditionally, an investment advisor will consider stocks, bonds, real estate and cash as primary types of asset classes. Using asset allocation, advisors recommend how much of total investment portfolio should be allocated to each asset class or type of investment.

The fixed asset allocation approach has proven somewhat effective in moderating overall portfolio risk. The strategy works by incorporating a mix of different asset classes with low statistical correlation (whose price movements tend to be out of synch with each other). It is then expected that the price movements of the asset classes especially in a volatile situation do not move together.

Fixed asset allocation is fundamentally a passive approach. It is based on an academic theory which says that the markets are efficient and that the price movement of investments cannot be predicted. However, there are weaknesses of the passive asset allocation method as well. At times certain assets in the allocation underperform resulting in inefficiency. The approach doesn't take the market conditions of any asset class into account.

Flexible / Dynamic Asset Allocation

Flexible asset allocation also called dynamic, tactical and active asset allocation can increase returns and also reduce portfolio risk. This strategy has grown in recent years due to the success of various computerized market timing techniques in analyzing market trends and therefore making it possible to adapt to market movements swiftly.

With this advanced technology, the asset allocation practitioner can respond dynamically to the market and significantly increase risk adjusted return over time by:

- Avoiding bear markets and periods of under performance in the various asset classes-either by reducing or eliminating the allocation of the under performing asset (eg, getting out of the market)
- Increasing the allocation of asset classes currently in bull markets.

Dynamic Asset Allocation through Mutual Funds

Dynamic asset allocation involves time bound rebalancing the allocation of fund (daily, monthly or quarterly), depending on the nature of the funds (terms defined).

Dynamic asset allocation involves reducing the positions in best-performing asset class, and adding to positions in underperforming assets. The strategy followed is 'Buy Low and Sell High'. In this strategy, investments are made in equities when markets are cheap with the intention to book profits when markets rise. Investments in such dynamic asset allocation funds deliver good returns, while reducing the risks.

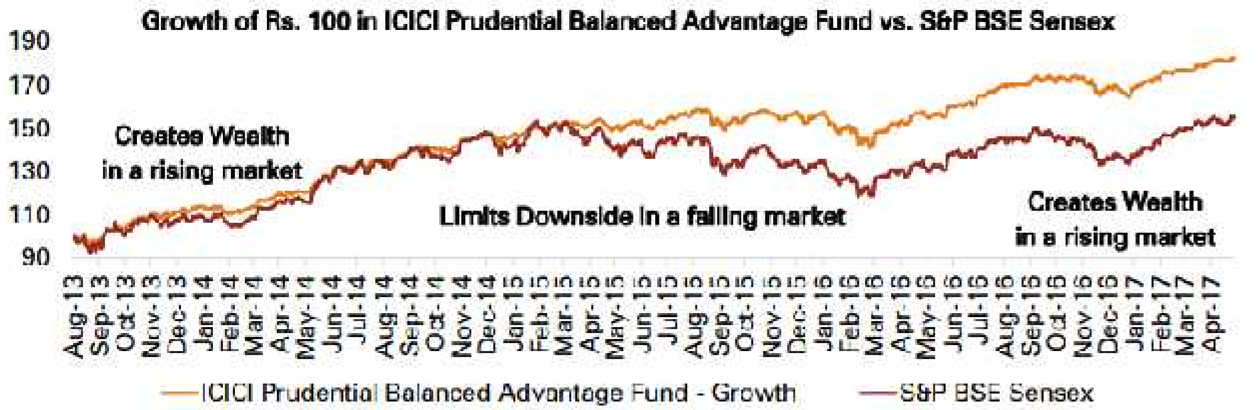
Presented below is an example of ICICI Prudential Balanced Advantage Fund through which we can study the impact of Dynamic Asset allocation on the long term performance of a mutual fund.

ICICI Prudential Balanced Advantage Fund uses an in-house model, based on a long-term historical mean Price to Book Value (P/BV), with a view to limit the downside risk during a falling market, while aiming to capture the upside in a rising market.

The fund allocates higher in equity when the Equity Market Valuation is low and lower when the Equity Market Valuation is high.

Period	ICICI Prudential Balanced Advantage Fund (%)	S&P BSE Sensex (%)	
1st Apr-15 to 31st Mar-16	0.7	-10.3	Limits Downside
1st Apr-14 to 31st Mar-15	26.6	24.9	Wealth Creation
1st Apr-13 to 31st Mar-14	20.3	18.7	Wealth Creation
1st Apr 12 to 31st Mar 13	13.2	8.3	Wealth Creation
1st Apr 11 to 31st Mar-12	5.7	-10.5	Limits Downside

Data in absolute % terms.



This Scheme is a blend of large and mid-cap stocks. While the large cap stocks represent established enterprises selected from the Top 100 stocks by market capitalization, the midcaps are smaller business entities with long-term growth potential.

The allocation is decided on a tactical basis rather than any predefined ratio. The Scheme uses derivative instruments for the purpose of hedging or portfolio rebalancing or for any other stock and/or index strategies as allowed under SEBI Regulations. The Scheme seeks to provide investors a reasonable opportunity to benefit out of market volatility, since the Scheme is structured with intent to benefit from such volatilities. The table and chart shown above reflects how 'Dynamic Asset Allocation' model of the fund has been able to protect investor's wealth in market downside and has outperformed the market on the upside.

CONCLUSION

Asset management in financial planning is gaining importance day by day due to higher expectations of the investors and growing volatility in the market. It remains the primary determinant of returns in portfolios made up of broadly diversified funds with limited market-timing.

Dynamic asset management performs better as it keeps on rebalancing the funds. To minmize risks and maximize profits, it buys at low prizes and sells when the maket is up. There are a number of success stories where dynamic asset management has been foud to be a promising option for the growth of ibvestment with less amount of risks involved.

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