A smart, and defensive, asset portfolio

Contrary to popular opinion, gold and real estate can at best preserve purchasing power against inflation over long periods

Since no one asks for daily prices of their gold and real estate, they are happy that they own something tangible. Photo: Bloomberg

There is a default 'Indian asset allocation'—50-70% in real estate and gold, remaining in fixed-income instruments. This is not taught but is hardwired in the culture and, so, learnt instinctively by most Indians, whether illiterate or highly educated.

Since no one asks for daily prices of their gold and real estate, they are happy that they own something tangible. Most Indians find out the value of gold and real estate only when they want to buy more or when prices are rising. When prices are dropping, these assets automatically drop out of the consciousness and discussions.

Contrary to popular opinion, gold and real estate can at best preserve purchasing power against inflation over long periods (20-30 years). Over shorter periods (5-10 years), they might look like growth assets since speculation drives up prices. This is followed by either sharp drops or stagnation for several years, with hardly any liquidity for real estate.

The next most popular investment with Indians is fixed-income instruments such as fixed deposits and debt mutual funds. These lead to loss of purchasing power due to inflation and taxes since the periodic interest is barely enough to compensate for these. Net of taxes, these instruments provided 5-5.5% returns over the past 10-12 years.

Inflation was nearly 7.5% over the same period, which meant losing purchasing power at 2% per year. Over 30 years, your wealth would be halved in terms of purchasing power. It's slow death.

The natural question is, how does one preserve and grow the purchasing power of one's wealth?

The most important instrument, and probably the only one that makes the economy to grow, is equity. Yes, it is risky. Privately invested equity faces business risks that an entrepreneur or small business faces. Publicly listed and traded equity faces speculative price risks, which could cause an equity portfolio to drop even 50-70%. This is why most Indians do not like to invest in equities.

To counter this returns-averse investment behaviour while taking cognizance of the natural risk averseness to losing capital, we revive and bring back a decades old asset allocation suggested by Benjamin Graham for defensive investors.

These are investors who either do not have an understanding of finance and investing or who do not have the time.

For them, Graham suggests a default allocation of 50% to equities and 50% to bonds.

For the even more risk-averse defensive Indian investor, a smart asset allocation of 60% in fixed income and 40% in equities is suggested.

This portfolio is 'smart' since it has to be allocated on day one in the said proportion and rebalanced annually to bring it back in line. It does not need too much thinking or time.

It automatically books profit in any asset class that has appreciated more and is likely to be overvalued, and allocates it to the other asset class, which is likely to be undervalued. So the questions, how to judge the right time, right level, amount to invest, exiting an asset class and others are automatically handled.

The appropriate exposure within each asset class is the only thing that needs to be decided. The fixed income portion should primarily have safe instruments such as government of India or AAA corporate bonds or bank fixed deposits. The equity portion should be primarily high quality, undervalued large-cap equities with an addition of mid- and small-caps. But since this may be difficult for a defensive investor to do, she could substitute the equity portion with Nifty (60%) and smaller-cap exchange-traded funds (ETFs) or index funds (40%).

The smart asset allocation portfolio has many characteristics similar to a fixed income portfolio. The primary aim of a fixed-income portfolio is preservation of capital. We did a study over the period of 2003-14. The smart asset allocation portfolio was able to preserve capital for about 90% of the times on a one-year holding period, and the worst portfolio still preserved more than 90% of its value. This is similar to

pure bond portfolios, which also lost nearly 10% over a one-year period. This includes the toughest period for equities, 2008-09, when equities fell 60-70%. Hence, on the “risk” side of losing capital, the two portfolios are similar.

However, in terms of returns, the long-term returns of the smart asset allocation are much higher at 16-18% per annum, versus 7-9% per annum returned by the pure bond portfolio.

Over a 10-year period, the smart asset allocation portfolio would multiply a defensive investor’s wealth by 5 times compared with 2 times with the pure bond portfolio. This means that someone investing `1 crore would have nearly `5 crore with a smart asset allocation portfolio and only `2 crore with a pure bond portfolio, in 10 years. Over 20 years, it would be `25 crore as opposed to `4 crore. And, over 30 years, `126 crore against a meagre `9 crore. Of course, there is no guarantee that this will happen.

Any investment portfolio is exposed to economies growing or shrinking and inflation and deflation. But a smart asset allocation portfolio is probably one of the best to guard against all of these risks since in a growing economy, equities will do well, and in a shrinking economy, bonds. Similarly, in an inflationary economy, equities are more likely to do well, and in a deflationary economy, bonds are likely to do well. Thanks, Benjamin Graham, from the defensive Indian investor.

Note: We have used a fixed income debt fund as proxy for the fixed-income portion and a 50-50 portfolio of ArthVeda’s Alpha L50 for ultra-large cap equity exposure and Alpha Div 25 for dividend-oriented, high quality, undervalued equities.

Vikas Gupta is executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd.