A Beginner's Guide to Asset Allocation

Asset allocation is an essential part of investment planning. The aim is to diversify your investments in order to enable you to mitigate the risk posed by market volatility.

What are the different asset classes?

You are spoilt for choice when it comes to asset classes! Assets can be allocated to one of seven broad categories:

1 Equity

- Investing in shares of companies listed on the stock market.
- A popular asset class, globally and in India
- Provides opportunity for capital growth in the long run and dividends
- Equity can also be accessed through mutual funds

2 Debt

- Bank fixed deposits, bonds, debt mutual funds, PPF etc.
- They aim to offer regular returns at a consistent rate; they are unaffected by market volatility.

3 Currency

- A sizeable and highly active currency market globally.
- Reasonably long price histories, as most modern currencies have been in existence for several decades.
- Currencies are exposed to country specific risk and macros.

4 Real estate

- Includes everything from apartments and villas to land and commercial buildings.
- Appreciates in the long run and can provide rental income

5 Commodities

- Covers raw materials, precious metals, mining products, agricultural products and more.
- Returns are determined by demand and supply fundamentals.
- They help hedge risk, as returns are largely independent of the stock market.

6 Cash

- A simple, liquid form of investment
- Keep cash in a savings account is a low-risk strategy.
- Cash is a safe investment but will not help much with wealth creation

7 Alternative investments

- Non-traditional asset class – includes art and antiques, hedge funds and private equity investing.
- Aims to generate huge returns but has low liquidity.
- Typically preferred by niche economic demographics, such as high-net worth individuals

HOW TO GO ABOUT ASSET ALLOCATION

These factors can help you determine the allocation that's right for you:

Investment goals and time horizon

- Do you want to save for higher education, buy a car or build wealth? All investing is outcome-based, so you need to start by knowing your desired outcome.
- Knowing your investing goal also helps to figure out the ideal time horizon, i.e. the time for which you stay invested in a particular asset.
- Fixed deposits and liquid mutual fund investments are good options for short-term goals like travelling.
- Equity investments and real estate work well for long-term investment goals like buying a house.

Risk tolerance and personality

- How comfortable are you with market volatility and the chance that your investment could lose value?
- Your risk tolerance depends on your income, number of dependents, and personality.
- Risk and returns are correlated – generally, the higher the risk, the greater the probability of higher returns.

Don't take your eye off the ball!

Asset allocation is not a one-time thing. Your investment portfolio should reflect the changes in your goals, income, and risk tolerance. Keep reviewing and rebalancing your portfolio regularly under the guidance of your financial advisor. Asset allocation and investment planning is easier when you have an expert to help you navigate it. Consult a financial advisor today!