Invesco Mutual Fund

Viewpoint: Asset Allocation to manage volatility

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Equity, one of the most interesting asset classes in the investment domain, is often slammed for its inherent volatile nature, which makes this asset class a rather risky venture from a short-term perspective.

But should that deter one from investing in Equities? Certainly, Not!

For while Equity is volatile, there are ways to better manage this volatility. One, is to invest in equity through equity related products, such as Mutual Funds, in a disciplined manner and on a regular basis and preferably with a long-term perspective. Other, is to allocate one's investments judiciously between equity and some other investment asset class that shares a relatively low or weak correlation with equity.

Low correlation between two or more asset classes implies that their degree of responsiveness to a situation or event is different i.e. when one asset class is adversely affected by an event, the other holds reasonably stable and vice-versa. A classic and simpler example of asset classes that share a low correlation is Equity and Fixed Income.

Equity, is inherently volatile, and so its returns are rather unpredictable in the short-term. But in the long-run, Equity, as an asset class is regarded for its potential to deliver higher returns and thus warrants a prominent position in one's investment portfolio to supplement wealth creation.

Fixed Income investments, in contrast, are known to generate stable returns over short to medium term, though the same may vary across time periods, based on factors such as interest rates and inflation. Besides, fixed income securities can also act as a shield against the interim market volatility, thereby limiting the portfolio's downside risk.

In effect, the two asset classes reasonably compensate for each other's limitations. So, while both Equity and Fixed Income are good individually, together, they can help offset the anomalies of their respective characteristics and help in mitigating broader investment risks.

If you assume this to be plain theory, let's validate it with factual circumstances.

- One of most volatile periods for Equity Market in recent history was the period from Jan '08 that extended until Mar '09. S&P BSE Sensex lost ~ 60.9% (in absolute terms) during this period (i.e. from Jan 8 '08 until March 9 '09). However Fixed Income, (represented by CRISIL Composite Bond Fund Index) gained ~7.8% during the same period.
- Likewise, from November '10 to December '11, S&P BSE Sensex lost close to 27.8% (in absolute terms) (from Nov 5, 2010 to Dec 20, 2011) while CRISIL Composite Bond Fund Index rose by 7.7%.
- More recently, from January '15 to February '16, when the S&P BSE Sensex fell by 22.7% (in absolute terms) (Jan 29, 2015 till Feb 11, 2016), CRISIL Composite Bond Fund Index generated stable 7.3% returns during the period.

This reasonably explains the strategic importance of both Equity and Fixed Income in an investment portfolio. But an area of concern here could be with regards to how much one should allocate to these two asset classes to generate optimum portfolio returns.

This concern is subjective and depends on the investors' risk appetite as well as in his / her comfort level in owning these assets. An investor here is thus advised to consult a financial advisor and / or to invest in professionally managed (hybrid) mutual fund schemes that are structured to invest in both Equity and Fixed Income in a pre-defined range for optimum results.