equaliFi ACADEMY

FPA

CERTIFICATE IN FINANCIAL PLANNING & ADVISORY

Session 4-Asset Classes and Allocation

Asset Allocation

- A portfolio is made up of several investment options across asset classes. The construction of the portfolio involves allocating money to various asset classes. This process is called asset allocation.

- In simple terms, asset allocation is the process of deciding how to distribute the investor's wealth among the various asset classes for investment purposes.

- Asset allocation also provides for a direction to the future income, cash flows of the investor in terms of where he should invest to achieve his financial goals.

Asset Allocation

- Investing in only one class of asset could prove to be risky.
- A fundamental justification for asset allocation is the notion that different asset classes offer returns that are not perfectly correlated.
- Hence, diversification reduces the overall risk in terms of the variability of returns for a given level of expected return.
- Therefore, having a mixture of asset classes is more likely to meet the investor's expectations in terms of amount of risk and possible returns.

Asset Classes

Cash	Meeting day to day and emergency requirements. Negligible returns but there is minimal risk
Bonds	Fixed return in the form of coupon/interest income Scope for capital appreciation when interest rates fall, capital erosion when interest rates rise. Corporate bonds are subject to credit risk of the issuer. Government securities are considered to be risk-free. Suitable for an investor seeking regular income flows with minimal risk.
Stocks	Ownership in a company. Highly risky in short run, but pay higher returns if invested for long run.
Real Estate	Investment in land or building or Real Estate Investment Trust (REIT). Management issues including tenancy, maintenance, legal clearances, illiquidity etc

Asset Classes

Gold	• Physical gold is stable investment and highly liquid. • Gold is generally used as a hedge against inflation.
Other alternative assets (Investment in Art / Collectibles)	• Investment are personal and emotional • Low correlation with other asset classes • Good for diversification • Subjective value, hence no exact measure for valuation • This asset class comes with very low level of liquidity

Asset Allocation & Financial Goals

- Asset allocation linked to financial goals is the most appropriate strategy
- Investor’s financial goals determine when the money would be required
- In case of long-term goals equity will be suitable
- In case of short term goal debt enables a stable growth
- A retired investor looking for a pension should invest in debt
- While implementing an asset allocation consider:

1. Investor’s risk profile based on ability and willingness to take risks
2. Financial Goal

Asset Class & Suitability

Asset Class	Return	Risk	Primary Objective	Time Period
Short term debt	Low	Low	Capital protection	Short
Medium term debt	Moderate	Low	Income	Medium
Long term debt	Moderate	Moderate	Income or growth at fixed rates	Long
Large cap equity	High	High	Growth with low income	Long
Mid and small cap equity	Higher	Higher	Growth	Longer
Private equity	Uncertain	Higher	Growth	Uncertain
Property	High	Moderate	Growth with rental income	Long
Gold	Moderate	Moderate	Growth	Cyclical

Asset Allocation Strategies

- Strategic Asset Allocation: Asset allocation that builds purely on the needs and preferences of the individual over the long-term is called strategic asset allocation (SAA). SAA is a long-term strategy where the choice of asset classes that will be part of the investment portfolio is usually based on the short-term and long-term financial goals set in place by the investor. The goal is to generate the targeted return while keeping the level of risk to the investor low.
- Tactical Asset Allocation: If strategic asset allocation is need-based, tactical allocation is view-based. Tactical asset allocation involves active portfolio management with the aim of adding value through short term adjustments in asset allocation based on the view for relative asset class performance.

Active vs Passive

Active

- Research backed
- Intends to generate Alpha
- Fund Manager
- Reasonable fees

Passive

- Follows an Index
- Deliver index returns
- Technology driven
- Low cost

Computation

Nit in Kapok's Future Plan: Example of FV

Facts ->

To buy a showroom in a mall after five years -> At present, the showroom cost is estimated to be Rs. 2 cores Assuming prices rise @ 4% p.a., how much will the property cost after five years? If Nitin wants to start saving for the showroom today, which asset class will be suitable? What amount should Nitin start saving on a Monthly basis?

Thank You