Smart asset allocation key to effective wealth creation

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Asset allocation is the process of distributing an investor’s wealth among different asset classes. In other words, it is investing money in assets such as equity, bonds, real estate, precious metals and other commodities to ensure that your investments are well-diversified.

Advantages

Reduces investment risk: A diversified portfolio is exposed to less risk as growth prospects are not limited to one security, but rather a basket of risky and non-risky securities across equity, debt, gold and real estate.

Less dependence on one asset class: Not all assets in a single asset class perform well at the same time. That’s why it’s important to choose different stocks and different categories of mutual funds. In fact, funds need to be allocated efficiently even within the category.

Hedge against volatility: Anybody who invested before or during the sub-prime crisis knows that when equities took a beating, debt and gold kept investors afloat. Those with pure equity portfolios are unlikely to repeat the mistake. A well-allocated portfolio will protect you, and even offer growth, during times of volatility.

Freedom from market timing: Those who try to time the market can testify to its volatility. Imagine timing market movement across different asset classes. Investing minus stress is not very hard if you stop timing the market and implement a disciplined strategy.

Asset allocation and diversification are not the same. Diversification can be explained by the adage, ‘don't put all your eggs in one basket’. it involves spreading your money across instruments in the hope that if one investment loses money, others will more than make up for the loss.

Many investors use asset allocation as a way to diversify investments across asset categories. For example, a 25-year-old investing for retirement can look at only equity, and a family saving for the downpayment of a house can invest entirely in cash equivalents. Though reasonable under given circumstances, neither strategy attempts to reduce risk by holding different types of categories. So, choosing an asset allocation model won't necessarily diversify your portfolio. Whether your portfolio is diversified or not will depend on how you spread the money among different types of investments.

Diversification

This should normally be done at two levels. One, across asset categories and, two, within a category. Apart from allocating investments towards stocks, bonds, real estate, precious metals, other commodities, private equity and other asset categories, you'll also need to spread investments within each category. The key is to identify investments in each category that may perform differently under different market scenarios.

One way of diversifying your investments within an asset category is to identify and invest in a wide range of companies and sectors. But the stock portion of your investment portfolio won't be diversified if you invest, for example, in just 4-5 stocks. You'll need at least a dozen carefully selected stocks to be truly diversified.

Each individual’s financial plans and investment needs are different, changing with the life stage. How an individual structures his asset allocation strategy should depend on his age, financial status, future plans, risk aversion and needs. Asset allocation is not an isolated choice, but a component of the portfolio management process.

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