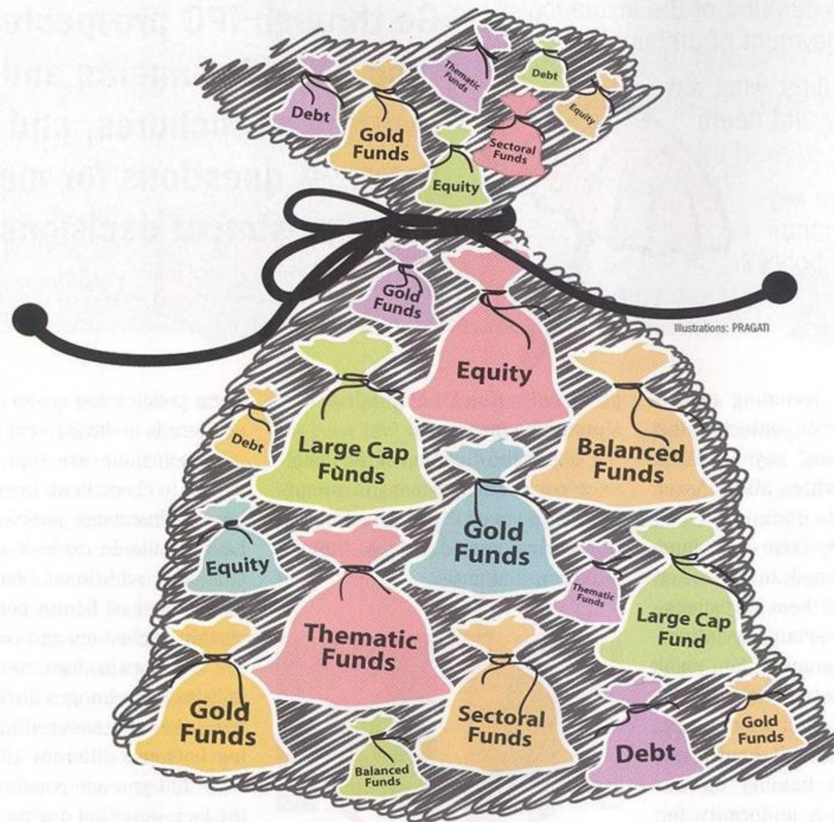


Illustrations: PRAGATI

Get a High from an Asset Cocktail

Diversification is the key to portfolio construction. Though spreading your risk helps in minimising losses, you should guard against 'over-diversification' | **By Tanvi Varma**

"Don't put all your eggs in one basket", goes the old adage. We all may have heard of this but seldom apply it while planning our finances. Based on your goals you may have allocated your investment into various asset classes such as equities, fixed income, insurance and commodities. But if you do not diversify within each asset class, the exercise, according to analysts, is sub-optimal.

Spreading your fixed income investments is fairly simple but in the case of equities you need the right permutations and combinations of different stocks or equity funds to ensure that your portfolio sufficiently straddles good sectors and stocks.

So, how much should you diversify? According to Rajeev Thakkar, chief executive officer, Parag Parikh Financial Advisory Services, diversification within equities helps to reduce the volatility of the portfolio as well as protects against big losses from improper selection of stocks. "Having said that, investors either end up with too little or too much diversification," he adds. You are inadequately diversified when you invest a large sum in a single stock, a handful of stocks or in a sector-specific mutual fund.

According to Ravi Gopalakrishnan, executive director and chief information officer – equity,

Pramerica Mutual Fund, sectoral funds typically come into favour for a short period and then lose steam. This can result in huge losses for the investors and sleepless nights.

And then there are investors who are over-diversified. These investors end up buying units of some 20 different diversified mutual fund schemes. This could mean double-diversification as one diversified fund alone gives you exposure to as many as up to 50 stocks-or prefer to invest small sums in stocks of hundreds of companies. "The more the number of companies and mutual fund schemes one is invested in, more will be the time and effort required to monitor those investments," says Thakkar.

The general thumb rule for optimal diversification, according to portfolio managers, is a holding of 20-30 stocks or investment in five to ten mutual funds across various themes.

THE BALANCING ACT

Different themes, offered as schemes by fund houses, outperform during different periods *(see chart)*. For instance, no index has remained the top performer through the period 2006 to 2011. The CNX Infrastructure index lasted at the top the longest, for about two years i.e. 2006 and 2007, driven by a roaring economy and the government's thrust on the sector – but has gone off-track since and is yet to recover.

So, those focused on infrastructure may have received stupendous returns in 2006 and 2007 but were also among the biggest losers- NSE's CNX Infrastructure index lost 56%-when the sector lost favour in 2008. On the other hand, those invested in the broader market, may not have made a killing in 2006 and 2007, but ended up with a limited downside of 50% in 2008, going by the fall in the Nifty. In fact this was even more pronounced in 2009 when the Nifty recovered to deliver a return of 72% compared to 36% delivered by the CNX Infrastructure index.

The midcap index, however, beat the CNX Infrastructure index in its race to the bottom by falling 59% between January 2008 and December 2008. Mid-caps tend to fall more than the large-caps during a downturn because of their high beta levels (more than 1), a measure of volatility of a stock in comparison to that of the stock market as a whole. Also, since these stocks are less liquid than large-caps, they are inherently more volatile. Financial planners say mid-caps should not be part of your core portfolio at any point of time.

Beta is a measure of the volatility, or systematic risk, of a security in comparison to the market as a whole. A beta of 1, for instance, indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market and will move more than the market.

A mix of stocks with different beta levels, can give you the growth and returns you need during boom time and cushion your portfolio when the bears take over. Many infrastructure stocks, for instance, have a beta of more than 1.2. So, these would provide you higher returns during a bull run while in a bear market it will fall as much. Stocks such as Jaiprakash Associates, Hindalco, and Sterlite are even more volatile with beta levels of more than 1.5.

On the other hand, stocks such as Cipla and Unilever have a beta of 0.5 and are considered defensives. The pharmaceuticals and the FMCG sectors, with their low beta levels do better than others in recessionary periods. Between January and December 2008 funds from the two sectors lost only 19% (pharma) and 25% (FMCG) compared to 51% loss by the Nifty.

SPREADING RISKS

Anil Rego, CEO & founder, Right Horizons, believes that diversified equity funds offered by mutual fund houses should form a majority in your portfolio, especially if you are a novice investor. "These funds provide wealth creation by investing across various themes and are underweight or overweight on sectors based on their outlook," says Gopalakrishnan. Over a five to ten year period they would perform better than the Nifty, he adds.

Although it is difficult to lay down rules for allocation across investment themes, certain types of funds can help you achieve certain goals you may have in mind. According to Rego, gold funds, for instance, could be used to plan for your child's marriage. Large-cap or balanced equity funds are low-risk funds, hence, are suitable for conservative needs such as buying a house, your children's education or

WHY DIVERSIFICATION?

BROADENS YOUR EXPOSURE

Diversification allows you to invest across asset classes, sectors, market capitalisation, themes, which enable a balanced risk reward ratio.

ENABLES GOAL-BASED APPROACH

Diversification allows you to invest into assets that suit your investment objective and help fulfill a particular goal.

REDUCES YOUR PORTFOLIO RISK

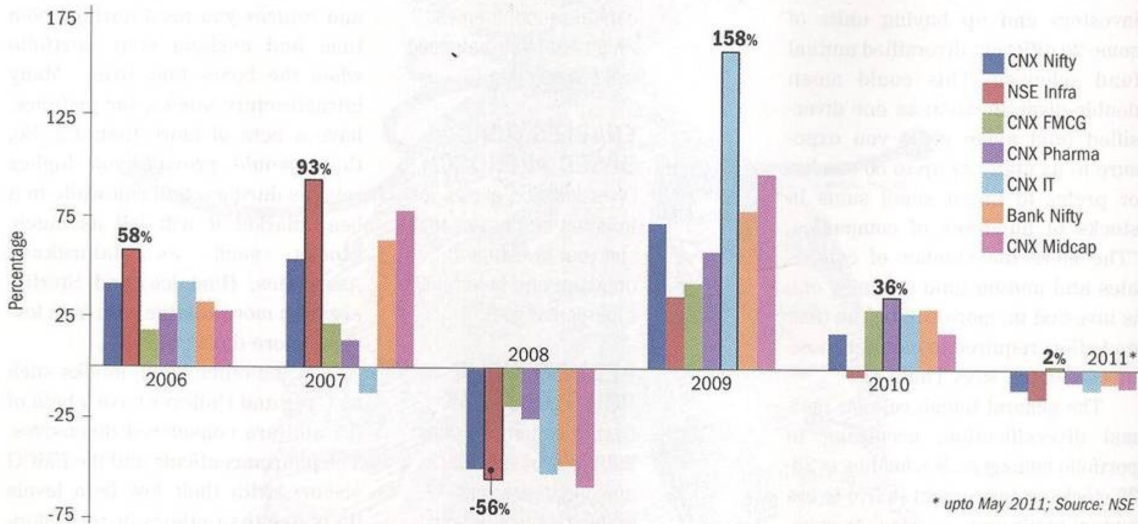
Diversification mitigates the effect of volatility in any one investment, thereby protecting and enhancing returns.

HELPS PROVIDE TIMING TRIGGER

You don't have to time the market. By virtue of being diversified this happens automatically.

Yearly performance of major indices since 2006

Various themes within equities have played out well during different time periods; making it imperative to diversify within the same asset class also.

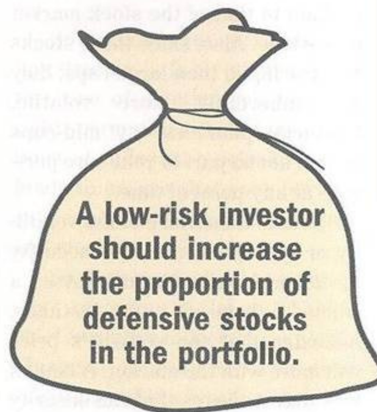


* upto May 2011; Source: NSE

retirement, he adds. Mid-caps or small caps should be used for near-term goals such as buying a vehicle or spending on a vacation because of their potential upside.

If you are a low-risk investor, increase the proportion of defensives in your portfolio such as FMCG, pharma or dividend yield stocks or funds; these will cushion your portfolio during market falls. But you should look at a two to three year time-frame for investing in such funds. The FMCG segment, for instance, continues to be plagued by margin pressures as input costs have been spiralling.

Further, thematic or sectoral funds can be used for taking advantage of market opportunities, but one must clearly identify a sector, says Gopalakrishnan. The sector needs to be identified by looking at the macro picture. Prior to 2008, the government's thrust was on infrastructure, which had a good run owing to factors like easy credit, benign interest rates, robust demand and soft commodity prices, leading to a good earnings cycle for them. However, in 2008, the government's focus shifted from investment to consumption. It reduced excise duties and interest rates, increased salaries through the Sixth Pay Commission and put money in the hands of the consumers. This benefitted the consumption-led sectors. Also the sector faced headwinds like limited offtake, high capital and commodity costs and procedural delays. "However, with the economy back on track, the focus has once again shifted back to infrastructure as well as commodities such as metals and cement," adds Gopalakrishnan.



NEED FOR CAUTION

Investments in any particular sector as a theme in your portfolio should be done on one's own only if you have the research expertise and conviction about the sector. You can look at investing 15-20% into sectoral funds, cautions Gopalakrishnan.

The short point is - diversify sensibly and guard against overdoing it. "Each fund should serve a purpose in your portfolio and any addition should ideally complement the portfolio appropriately," says Rego.

Further, increase in the number of stocks beyond 30 will only dilute the performance of the best ideas. "Some call this 'di-worsification' of the portfolio," says Thakkar. And as you approach retirement don't forget to rejig your portfolio to reduce the number of high-risk investments.

Legendary investor Warren Buffett, who does not recognise volatility as a risk and advocates a concentrated portfolio, qualifies that his approach is not suitable for everyone, definitely not for relatively inexperienced investors. MT