Simple Asset Allocation Portfolio

Asset Allocation portfolios have gained significant traction in the past few decades. A combination of prolonged loose monetary policies and low inflationary environment have created the perfect hunting ground for investors looking to invest in relatively stable long-term investing portfolios. One of the largest hedge funds in the world, Ray Dalio's Bridgewater, outshined its peers in the Great Financial Crisis (producing double-digit returns) because of their ability to timely allocate to a diverse set of markets.

Let's try to understand what works in Asset Allocation portfolios, and how can an investor in Indian markets create an Asset Allocation portfolio.

"Diversification is the only free lunch"

Harry Markowitz, the inventor of Modern Portfolio Theory

Asset Allocation investors have taken full advantage of the free lunch of diversification. The privilege of having access to global markets, not just in different asset classes but also in different geographies have been extremely helpful to Asset Allocating investors. Here the legendary investor Ray Dalio, the founder of Bridgewater, explains his 'Holy Grail' in investing.

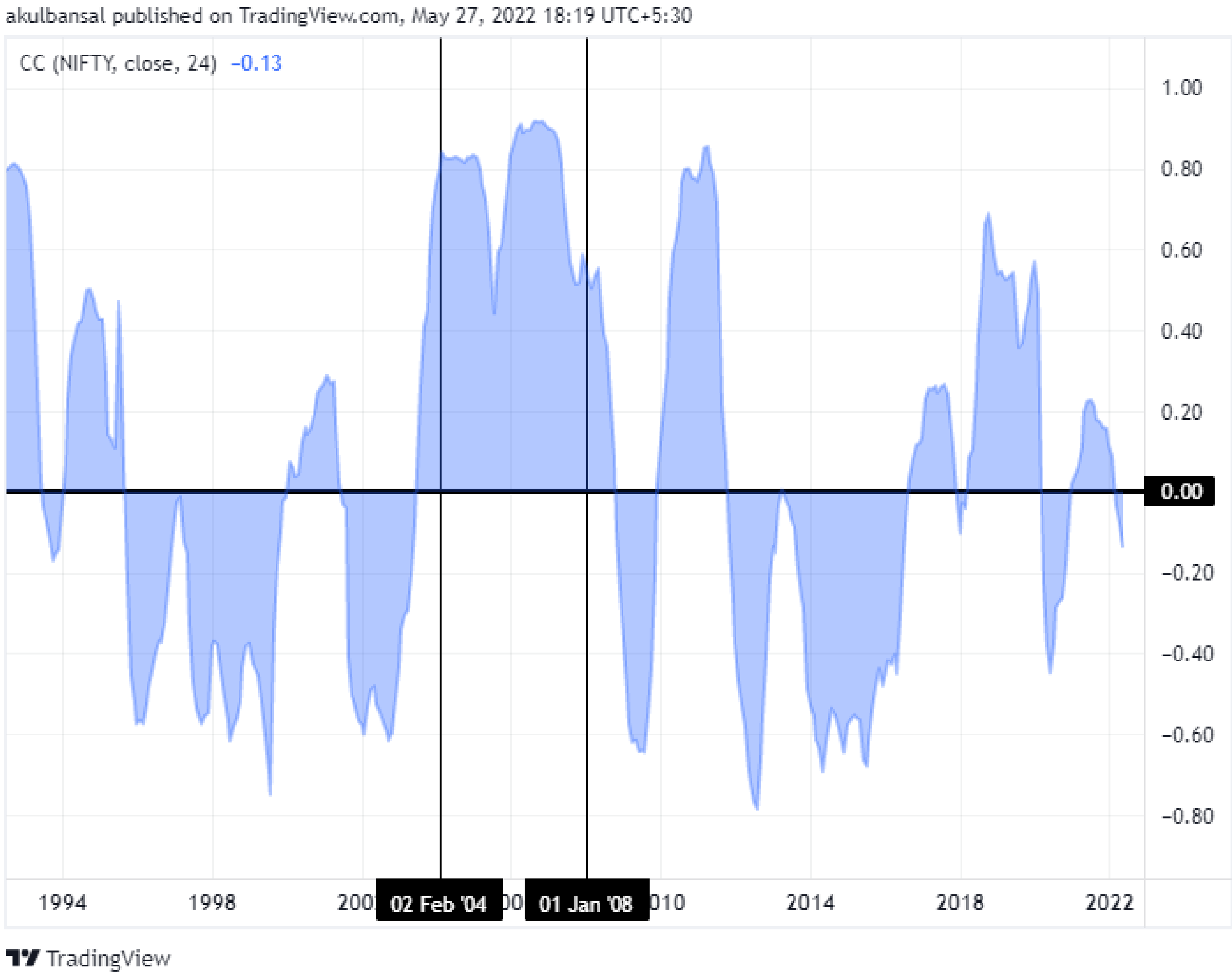
What Ray Dalio is trying to explain here is adding uncorrelated (low correlation) return streams lowers risk in a portfolio without giving up on returns. The lower the correlation between return streams, the more return streams you can add and the lower the risk will be, assuming returns across the different return streams are comparable.

Among other asset classes (namely, real estate, commodities and alternatives), equities and bonds make up most of the asset allocation portfolios. Low and stable inflationary since 2000 has resulted in an environment of negative correlation between equities and fixed income. Now, constructing a portfolio with two of the most integral assets having negative correlation boosts returns significantly; when one return streams incurs losses, the other return streams makes up for the losses and protects the portfolio (a tactical portfolio will get further benefit from this by overweighting the return stream that is generating positive returns).

The benefit of having uncorrelated returns streams doesn't end at just the ability of having different streams in your portfolio generating returns at different times. The real kicker that significantly increases returns is the ability of exploiting long-term mean reverting behaviour of asset classes returns. For example, most market participants are aware of how cheap equities are in the middle of a recession (usually the end of the bear market). The problem most participants face: the lack of liquidity to be able to buy into equities because they have already been investing throughout the bear market (which means they are short of liquidity to buy any more equities). This problem can be tackled by adding return streams that are negatively correlated (or at least uncorrelated) when you need diversification the most; having a part of your portfolio generate liquidity when the equities in your portfolio are falling through the floor will give you enough liquidity to be able to buy into equities when they are the cheapest!

Okay, so we understand that we need uncorrelated return streams to construct a high-return-low-risk portfolio. If you can get your hands on negatively correlated return streams, don't think twice and just add those return streams in your portfolio. Investors who have spent considerable time into understanding understand this concept of having uncorrelated streams pretty well. The problem investors in India face is lack of global market access. This makes it much more difficult to find uncorrelated return streams that you can add in your portfolio. The solution: GOLD, the asset we Indians are known for investing in. *Exhibit a* shows 24-month rolling correlation between Gold and Nifty. It has stayed negative for most part of history, except the 2004-08 period, during which diversification was detrimental anyway because the markets were conducive to all kinds of investors.

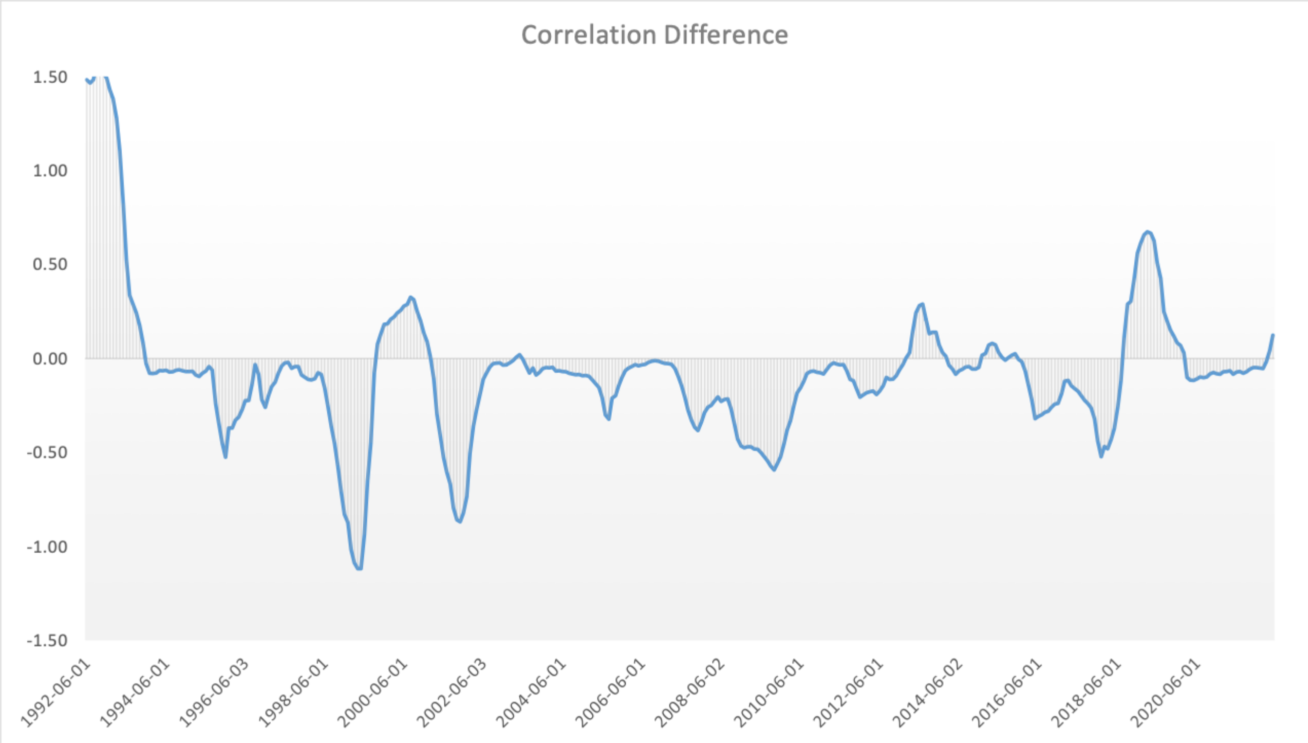
Exhibit a: Rolling 24-month correlation between Nifty and Gold (INR)



The benefit of adding Gold works wonderfully well for Indian investors because of one often overlooked feature: pricing of Gold is denominated in the U.S. Dollar and you will be buying Gold that is priced in the Indian Rupee. India being a developing nation (and for many other reasons such as demographics), has had and will tend to have a higher average inflation rate than U.S. What this means for you, as an investor in 'Indian Gold', is that your portfolio gains whenever the INR depreciates against the U.S. Dollar; INR tends to depreciate against the U.S. Dollar during crises because U.S. is considered as a safer country so the capital moves out of Indian assets and into U.S. assets.

Exhibit b shows the difference between the correlations of GoldUSD-Nifty and GoldINR-Nifty. A quick glance at this chart makes it clear that Gold-denominated-in-INR has much lower correlation with Nifty than Gold-denominated-in-USD with Nifty. This effect is in part a reflection of negative/low correlation between Indian equities and USDINR exchange rate; as global investors reduce risk (*risk-off*), emerging market equities, and currencies alike, tend to get sold.

Exhibit b: Difference in correlations of Gold (INR) w.r.t. Nifty and Gold (USD) w.r.t. Nifty



A basic asset allocation portfolio which allocates equal risk weights to Equities, Gold, and Bonds can deliver the high-return-low-risk portfolio most investors strive for. I will, soon, write a follow-up post on how investors can create such an asset allocation, with as low churn and costs as possible.