How to Adapt your Asset Allocation for Different Market Phases

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In my last post here, I had discussed on how to choose your asset allocation.

Equity markets usually trade around their fair value range majority of the times. But there are also those phases where equity markets become insanely overvalued or unbelievably cheap.

There are two schools of thought on how to approach these extreme phases:

1st School of Thought:
- While it is true that markets may get insanely expensive or cheap, these phases are extremely difficult to identify except in hindsight.
- Market movement cannot be predicted – stick to original asset allocation

2nd School of Thought:
- Based on certain parameters the extremes of the market can be identified and asset allocation should be adjusted accordingly
- This school of thought, while definitely is more appealing, is also super difficult to pull off consistently

My approach is a blend of both.

First school of thought, will mean I won't be taking any extreme positions. All-In or All-Out allocations from Equities will be avoided.

Second School of thought will imply I will try to do some adjustments (but nothing drastic).

Let us see how this translates into my actual framework.

There are 3 parts to it

- Regular Rebalancing
- Bear Market Plan
- Bubble Market Plan

1.Regular Rebalancing

This is a simple form of rebalancing, where each and every year when you review your portfolio, if any asset class allocation exceeds or falls short by 5% of the original intended allocation, then you bring it back to the original levels.

Let me explain with an example. Assume you have decided on 50% Equity and 50% Debt Allocation.

Now after a year, during the review, you find out that due to a market rally the equity allocation has increased to 58% and correspondingly debt allocation is now at 42%.

Since Equity allocation exceeds the original allocation by 8% (which is more than our threshold of 5%), we will shift some portion of equity to debt and bring the overall asset allocation back to 50%:50%.

This is a super simple yet very effective way to manage your risk and improve your returns over the long run. Backtests indicate roughly around 1-1.5% improvement in returns by doing this simple activity.

Research (link) also shows that returns are not meaningfully different whether a portfolio is rebalanced monthly, quarterly, or annually.

So in terms of rebalancing frequency you can either choose to do it once a year or once every 6 months (but be mindful of tax & exit load implications).

For most of us, we will also keep getting new money to be deployed at regular intervals. In that case every time you are adding new money, you can try to align it back to the original allocation and this can address taxation and exit load issues to a large extent.

2.Bear Market Plan

I will address the Bear Market Plan i.e how to adjust equity allocation during a market crash separately in the next post.

3.Bubble Market Plan

Let us start with the basics. A bubble essentially means that the equity markets have become insanely expensive. So any negative event whenever it hits can cause the markets to crash.

This line of thought argues for much lower allocation to equities than your original allocation.

That being said there are **two major concerns** with this approach

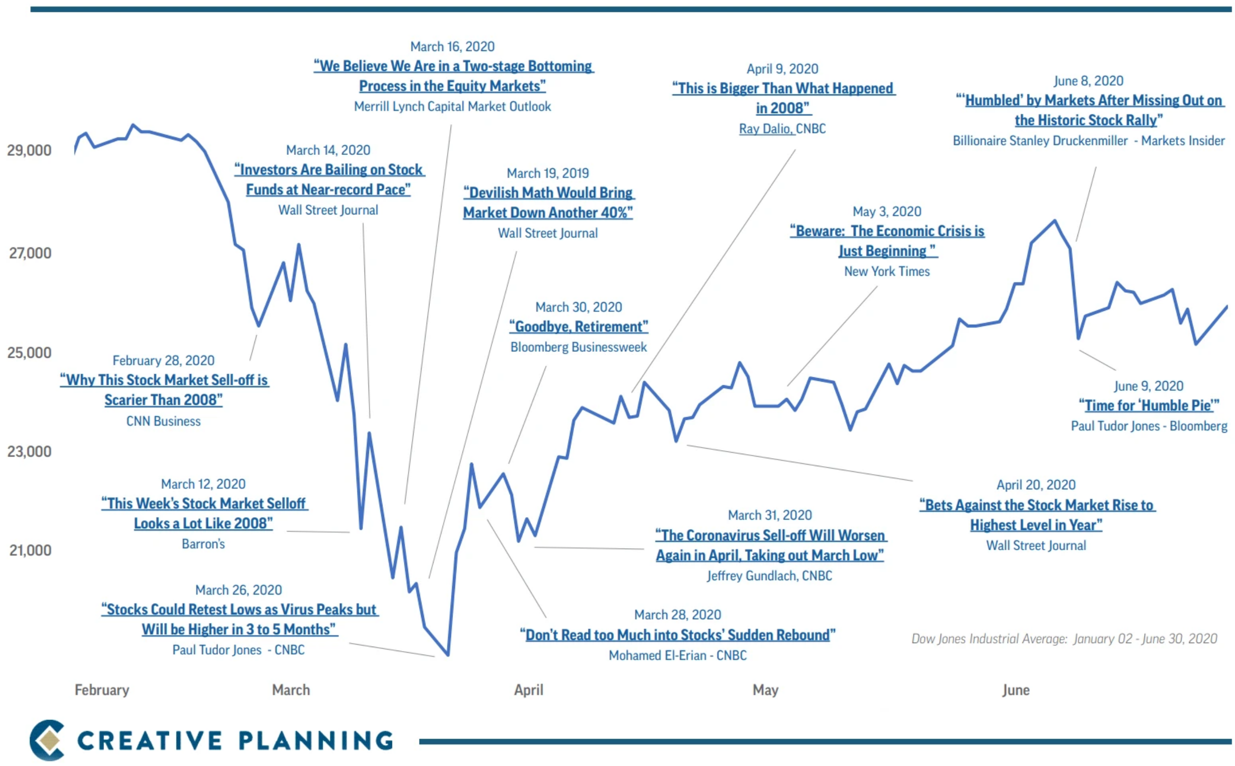
1. **A bubble market can go on for a long time (sometimes several years) and become extremely frustrating if you are completely out of the markets.**
2. **Calling a bubble market top is super difficult – even the best have got it wrong!**

Sample this…

Date	Armageddonist	Quote
May 20, 2010	Nouriel Roubini	"There are some parts of the global economy that are now at the risk of a double-dip recession. From here on I see things getting worse." - *CBS*
June 4, 2011	David Rosenberg	"Another recession is coming, and soon. So says Gluskin Sheff economist David Rosenberg. Rosenberg, a longtime bear on the economy and the stock market, now says he is 99% sure we will have another recession by the end of next year." - *Fortune*
August 9, 2011	Jeff Gundlach	"It seems suicidal to buy a broad-based basket of stocks or economically sensitive commodities or emerging markets stocks - all of which are very leveraged to economic growth" - *Kiplinger;* and "Sell everything, nothing looks good" in July 2016 - *Reuters*
February 24, 2012	Lakshman Achuthan	"Lakshman Achuthan, co-founder of the Economic Cycle Research Institute, said on Friday that his research firm is sticking with the forecast it made in September: A new recession is inevitable, despite improvement in high-profile economic indicators, such as job creation and unemployment, and a stock market rally. Achuthan said data gathered since his September forecast only confirms his view that economic growth has slowed to such a degree that a downturn is now unavoidable, likely by late summer." - *CNN*
May 25, 2012	Marc Faber	"I think we could have a global recession either in Q4 or early 2013. That's a distinct possibility." When asked what were the odds, Faber replied, "100%" - *CNBC*
November 12, 2012	Robert Wiedemer	"The data is clear, 50% unemployment, a 90% stock market drop, and 100% annual inflation starting in 2013." - *Newsmax*
March 31, 2013	David Stockman	"When the latest bubble pops, there will be nothing to stop the collapse. If this sounds like advice to get out of the markets and hide out in cash, it is." - *Business Insider*
April 25, 2013	Albert Edwards	"We repeat our key forecasts of the S&P Composite to bottom around 450 (-70%), accompanied by sub 1% US ten year yields" - *CNBC,* following on Edwards' "ultimate death cross" in July 2012
May 30, 2013	Peter Schiff	"We've got a much bigger collapse coming...I am 100% confident the crisis that we're going to have will be much worse than the one we had in 2008" - *Marketwatch,* and "The crisis is imminent. I don't think Obama is going to finish his second term without the bottom dropping out. And stock market investors are oblivious to the problems." - *Money Morning*
October 15, 2013	Tom DeMark	"DeMark's Dow Jones Index chart covering the period from May 2012 to the present seems to be tracking, almost precisely, the months leading up to the 1929 stock market crash." "The market's going to have one more rally, then once we get above that high, I think it's going to be more treacherous... I think it's all preordained right now." - *Bloomberg*
November 6, 2013	Bob Janjuah	"We see a significant risk-on top before giving way, over the last three quarters of 2014 through 2015, to what could be a 25%-50% sell-off in global stock markets." - *Marketwatch*
July 24, 2014	David Levy	"David Levy says the United States is likely to fall into a recession next year, triggered by downturns in other countries, for the first time in modern history. "The recession for the rest of the world ... will be worse than the last one," says Mr. Levy, whose grandfather called the 1929 stock crash . Mr. Levy predicts a US recession will throw its housing recovery in reverse, and push home prices below the low in the last recession. He says panicked investors are likely to dump stocks and flood into US Treasuries, a haven in troubled times, like never before." - *The Independent*
September 29, 2015	Carl Icahn	"I see real tremendous problems ahead and I don't think we are handling it right and nobody really wants to talk [it] out... We are headed toward a strong correction and possibly a complete meltdown but not systemic like 2008. It won't threaten the system, it's just going to threaten your livelihood and net worth....I do think you are in a very massive bubble and when it bursts it isn't going to be pretty, it could be a blood bath." - *Forbes*
January 7, 2016	George Soros	"Global markets are facing a crisis and investors need to be very cautious, billionaire George Soros told an economic forum in Sri Lanka on Thursday..."China has a major adjustment problem," Soros said. "I would say it amounts to a crisis. When I look at the financial markets there is a serious challenge which reminds me of the crisis we had in 2008." - *Bloomberg*
January 18, 2016	John Hussman	"A broad range of other leading measures, joined by deterioration in market action, point to the same conclusion that recession is now the dominant likelihood." - *Hussman Funds*
October 31, 2016	Simon Johnson	"Mr. Trump's presidency would likely cause the stock market to crash and plunge the world into recession...anti-trade policies would cause a sharp slowdown, much like the British are experiencing after their vote to exit the European Union." - *New York Times*
November 9, 2016	Paul Krugman	"It really does look like President Donald J. Trump, and markets are plunging....So we are very probably looking at a global recession, with no end in sight. I suppose we could get lucky somehow. But on economics, as on everything else, a terrible thing has just happened." - *New York Times*

Source: Link

and here we go again in the recent crash...



To balance both the above factors, I would suggest not reducing the equity allocation below half of your original equity allocation.

For eg if your original intended asset allocation was 50%, in case of a bubble market you can reduce it up to 25%. Say your original intended asset allocation was 70%, in case of a bubble market you can reduce it up to 35% and so on. You get the drift.

Worst case you get your call on the bubble market wrong, you have still built a humility net which is the remaining 50% of the original equity allocation.

I would suggest going underweight in two tranches:

- **Trigger 1:** Reduce to 75% or 3/4th of original equity allocation
- **Trigger 2:** Reduce to 50% or 1/2th of original equity allocation

Cool. Now comes the most important question

How do I decide on the Trigger 1 and Trigger 2?

Now before I go further, I have a honest confession. I have a fairly good and practical framework for increasing equity allocation in a bear market and have also seen it work really well both for me and my clients during the Covid crash.

But when it comes to evaluating a bubble zone, it is still work in progress and has not been tested real time (as I am yet to experience a bubble firsthand). This is mostly built from studying past market crashes both in India and other countries. So take my approach with a pinch of salt.

Now with the warnings out of the way, let us dive into the approach

Starting with the Basics

How to decide when to go underweight on equities?

If future returns from equities are going to be low – go underweight!

But how do we approximate the equity returns of the future?

For this, let us deconstruct equity returns into its components

Next 5Y Equity Returns = Change in Earnings + Change in Valuation (Price to Earnings multiple) + Dividend Yield

Dividend Yield for the Nifty 50 is usually roughly around 1-1.5%. So in essence if we get a rough sense of earnings growth and valuation change we can roughly estimate the future returns.

Approach for Valuations:

History shows us that, valuations don't stay extremely expensive or cheap for a long time. They eventually come back close to their long term averages. So the extent of valuation deviation from long term averages, can be used as a rough proxy to identify valuation extremes.

Also instead of one indicator, I prefer using a mix of valuation indicators and see if all valuation signals point towards the same direction. If the indicators are showing, different signals, then it means we need to check for the context involved.

I will be evaluating valuations via three factors

1. Price to Earnings Ratio
2. Price to Book Ratio
3. Market Cap to GDP Ratio

Based on the evaluation of the above 3 with respect to historical averages, you can take a stance on where the valuations are – High or Moderate or Low

Approach for Earnings Growth:

While it is impossible to exactly predict earnings growth, the idea is to find out where we are in the earnings cycle. If you look at history, the equity markets go through periods of strong earnings growth followed by weak earnings growth and again the cycle continues.

So if we can evaluate where we are in the cycle, then we can build a rough expectation around the likely earnings growth environment over the next 5 years.

For this we will be looking at several factors such as:

- Past Earnings Growth
- ROE Cycle
- Corporate Profits to GDP
- Interest Rates
- Credit Growth
- Capacity Utilization
- Other Factors – Oil Price, Government reforms etc

Based on the evaluation of the above factors with respect to history, you can take a stance on where we are in the earnings growth cycle – Bottom of Earnings Growth Cycle or Middle of Earnings Cycle or Top of Earnings Cycle

Putting them together

Once you evaluate both, here is how this translates into the decision making.

	Bottom of Earnings Cycle	Moderate Earnings Cycle	Top of Earnings Cycle
High Valuations	Neutral	Underweight	BIG Underweight
Moderate Valuations	Overweight	Neutral	Underweight
Low Valuations	BIG Overweight	Overweight	Neutral

For Trigger 1 (Underweight to 75% of original equity allocation) to happen, these are the scenarios

- **Scenario 1:** Top of Earnings Cycle + Moderate Valuations
- **Scenario 2:** High Valuations + Moderate Earnings Cycle
- **Scenario 3:** Extremely High Valuations + Bottom of Earnings Cycle

For Trigger 2 (BIG Underweight i.e reducing to 50% of original equity allocation) to happen, 2 conditions should be satisfied

- **Condition 1:** Top of Earnings Cycle
- **Condition 2:** High Valuations

How to build a framework?

What I explained above is the underlying thought process. As a part of my firm, I track around 25 factors to take a view on the above.

Now to be honest, because I am a part of a large firm and do this as my dayjob, I have the luxury and time to build fairly elaborate frameworks.

But this can become a little overwhelming for a normal investor.

So how about doing a little jugaad and building something equally efficient?

Here is my suggestion:

For Trigger 1 (reduce to 75% of original equity allocation): Use VALUATIONS as an indicator

Consider it as High Valuations (or Trigger 1) when any 2 out of 3 conditions are satisfied

1. Equity Allocation of ICICI Balanced Advantage Fund <45%
2. Equity Allocation of Kotak Balanced Advantage Fund <40%

3. MCAP/GDP>100%

So if any of the above two conditions are satisfied reduce equity allocation to 3/4th or 75% of the original equity allocation levels.

ICICI Balanced Advantage Fund runs an asset allocation model based on Price to Book and has worked reasonably well over the last 10 years. Check here to find out the equity allocation.

Kotak Balanced Advantage Fund's asset allocation model is based on Price to Earnings and the good part is they also adjust it to account for depressed earnings during market crash periods. Check here to find out the equity allocation.

For MCAP/GDP you can check here

For Trigger 2 (reduce to 50% of original equity allocation): Trigger 1 + Top of Earnings Growth Cycle

Apply if two conditions are satisfied:

- **Condition 1:** Trigger 1 has already been triggered
- **Condition 2:** Top of Earnings Growth Cycle

How do we check for top of earnings growth cycle?

You can use the below three factors

- Last 5 year earnings growth
- Corporate PAT/GDP
- Nifty ROE

If all the three are close to their highs (with respect to long term history), then it implies we are close to the top of the earnings cycle.

Right now we are at the bottom of the earnings cycle. So Trigger 2 is ruled out for the time being.

How to go underweight?

Given what happened to the US markets for the last 10 years where it continued to rally despite high valuations, I am usually extremely cautious when it comes to going underweight.

So instead of going out from equities into debt for underweighting, I would suggest going underweight using Dynamic Asset Allocation funds (also called Balanced Advantage Funds).

These are funds which automatically increase and decrease equity allocation based on valuations.

So going underweight both in Trigger 1 and Trigger 2 will be via Dynamic Asset Allocation Funds.

If Trigger 1 happens, then reduce your equity allocation by 1/4 th of original allocation. This 1/4th of original allocation will be shifted to Dynamic Asset Allocation funds. Eg If your original equity allocation is 50%. Then for Trigger 1, shift 12.5% of your equity allocation into Dynamic Asset Allocation funds. The new asset allocation will look like 37.5% Equity + 12.5% Dynamic Asset Allocation Funds + 50% Debt.

Does this become too tempered?

We need to remember that our original asset allocation, has already built a layer of safety via debt funds based on our ability to tolerate declines. So this is only adding one more layer of safety and hence the need to be a lot more tempered.

Going underweight comes loaded with the second issue – how to bring back to original allocation?

Here is the rule:

2 conditions have to be satisfied to get back to the original equity allocation by shifting to pure equity funds.

- **Condition 1:** Kotak BAF equity allocation goes above 60%
- **Condition 2:** ICICI Prudential BAF goes above 65%

Since we have gone underweight using Dynamic Asset Allocation funds, worst case you panic and are not able to increase equity allocation back to original levels during a market fall, the Dynamic Asset Allocation funds will automatically increase the equity allocation. So this becomes a behavioral safety buffer that we have built.

Final Thoughts

Of course, there is nothing sacrosanct about these rules and you can evolve your own ones.

But the key idea is that we need to have clear, logical, evidence backed rules and a plan well ahead of the bubble market.

In an actual bubble market without these rules it will be extremely difficult to execute our plan as greed will set in. Most of us tend to overestimate our abilities to handle greed.

If all this seems to much to handle, absolutely no worries. Once you have decided on your original asset allocation a simple yearly rebalancing (with a 5% threshold) is a good enough solution.

So, this is how you can prepare your own plan to handle a bubble market.

If you have any feedback or thoughts you can also mail me at rarun86@gmail.com.

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