**Asset Allocation and Factor-based Systematic Equities Model for Indian Retail Investors**

This document lays out all ideas that will drive the investment decision makin of r-value as a systematic equities model. The primary objective of the rules defined in the document is to adjust allocation to ‘growth’ and ‘store of value’ asset classes for Indian retail investors. Therefore, it focuses only on those asset classes that are readily available for retails investors in India. These include domestic stocks, foreign stocks, gold, and cryptocurrencies.

The primary goal of this investment framework is to maximize risk adjusted returns. Therefore, we avoid debt assets denominated in INR (Indian rupee) as we think that the rupee continuously devalues both against other major currencies like the US dollar and also in terms of its purchasing power, which makes the real returns on debt assets negative.

1. **Stocks:**

**Interest Rate Cuts**: When the government cuts interest rates, the money supply increases and if it is done by quantitative easing – that is, if money is disseminated to commercial banks, it ends up in the hands of individuals and companies. When individuals spend and companies have better access to credit, it drives a growth cycle. Stock prices rise as a result. But, it is important to understand that investors usually already price in the effect on interest rate cuts – therefore, the market would react positively only if the cut is bigger than expected.

**Rule 1:** If we expect an interest rate cut that is bigger than expected, we should increase allocation to equities

**Price to Earnings:** There is not much value in looking at historical earnings growth. Instead there is more value in looking at earnings growth expectations. If the next quarter earnings growth expectations are low – and P/E does not decrease, we should decrease equity allocation. If they next quarter earnings expectations are high, we should stay invested or increase equity allocation.This is rather important when P/E is high and investors are less wary about growth expectations. Any P/E of > 25 should require a reconsideration, and evaluation if companies can keep up with the pace of growth expected by the market.

**Rule 2:** At higher P/E values it is important to evaluate expected earnings growth and decrease allocation to equities. At low and moderate P/E values, we can increase allocation to equites unless there are major macro-economic issues that would stall growth for long periods.

**Inflation:** Inflation is an important forward looking indicator of upcoming economic slowdown or recession. If inflation is rising beyond a certain point, it means that productivity is not able to keep pace with the money supply. In such a scenario, the central bank would have to increase interest rates to bring down inflation. If there is already a slowdown in growth, this can be a bad thing. Increasing interest rates will make credit costlier and put further pressure on economic growth. This will lead to a deflationary cycle.

**Rule 3:** Increasing inflation is the first sign of an imminent economic slowdown. Inflation has to be compared to interest rates and the rate of growth**.** If there is a substantial increase, we should decrease allocation to equites.

**Geographical Diversification:** At any given point in time we have the choice to invest in equities from India, US, China, Taiwan, and Japan. We prefer to keep most of the allocation to Indian equities given that it allows more flexibility in terms of stock picking as the investment vehicles for foreign equities are limited to funds and ETFs that give exposure only to the broader market. Therefore, our investment approach only defines rules that drive allocation out of the Indian market when we think it is overvalued or when macro-economic conditions in India are unfavorable.

**Rule 4:** If the Indian market is overvalued, or economic conditions are unfavorable, we diversify out of Indian equites to other markets that are relatively undervalued. If all other markets seem overvalued, we allocate to gold.

**Factor Weights:** Within the allocation to Indian equities, we focus on standard factors from Cahart’s 4-factor model – market, size, quality and momentum. We study the performance of these factors in different macro-economic conditions and assign suitable weights to these factors based on the current macro-economic condition, and market valuation.

**Rule 5:** Assign factor weights to Indian equities based on macroeconomic conditions and market valuation.

**Cryptocurrencies:** Cryptocurrencies as asset classes are essentially of two kinds - store of value, and growth cryptocurrencies. Bitcoin is gaining traction and adoption as a store of value asset with institutional participation, but there are caveats like high volatility, huge private ownership, and smaller track record compared to gold. Institutions are exploring the sizing of bitcoin in multi-asset portfolios and how it can fit with other asset classes. Other cryptocurrencies that I describe as ‘growth’ cryptocurrencies are more like software companies.They provide a platform-as-a-service, which is essential the cryptocurrency’s network, that allows the development of real world applications on the network and transactions at low costs and high speed. Ethereum and Solana are examples of ‘growth’ cryptocurrencies.

**Rule 6:** Cryptocurrencies are risky assets with less history which means that what we understand about them and we anticipate their performance would be is uncertain. I avoid Bitcoin, and rather choose gold as a store of value. I keep some allocation to ‘growth’ cryptocurrencies bases on their network features, adoption and real-world use cases. Solana has better speed and lower costs than Ethereum. It also has several real-world use cases with Visa, Instagram and other big names. Therefore, I allocate a portion of my portfolio to Solana – not as a an asset diversification, but rather as another ‘growth’ asset only for returns.

**Gold**

Gold is our ‘store of value’ asset class and is basically like a last resort when we do not find any room for investment in any of the ‘growth’ assets. Several conditions might lead to such a state where we do not find any opportunities in ‘growth’ asset classes, for example,

Too much debt and currency devaluation, high geopolitical conflict, calamities and disasters, or any other disastrous event that with a large scale effect on global productivity.

Whenever there is too much addition of debt too quickly, and if this is done for a long time, the debt levels can reach unreasonable and dangerous levels. This devalues the currency in which the debt id denominated. The US has the largest debt of any country in the world. As the government runs a deficit, or cuts interest rates, this debt keeps rising because GDP growth is not as fast. This will always create an environment of uncertainty and devalue currencies.Since the dollar is a the reserve currency, it does not devalue, but the risk prevails.But other currencies devalue against the dollar.

**Rule 7: If the rupee keeps devaluing, and US debt keeps rising, and if there is geopolitical uncertainty, we should increase allocation to gold.**

These 7 rules primarily drive the investment decision making in our framework for asset allocation.