BUILD A BALANCED INVESTMENT PORTFOLIO

Chapter 13

A BEGINNER'S GUIDE TO MUTUAL FUNDS

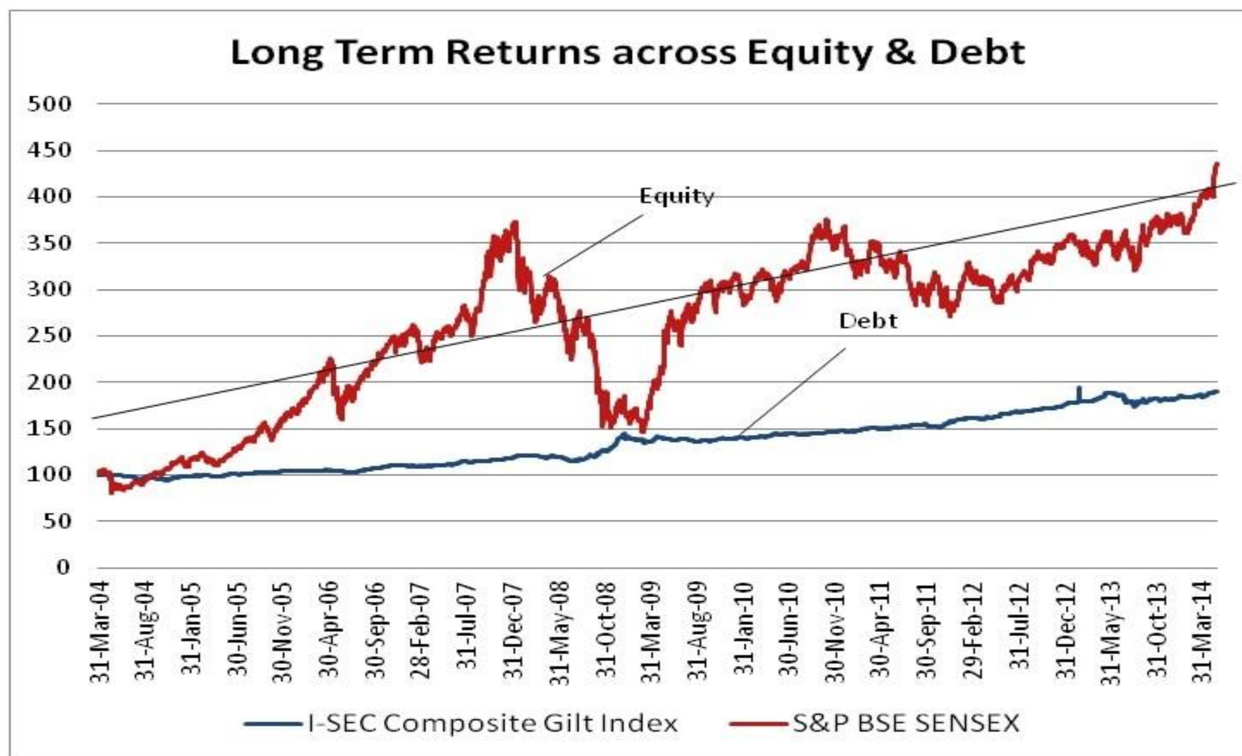
To understand how to build a portfolio, we need to understand what the term means and what it implies. The original meaning of the word 'Portfolio' is simply a bag designed to carry documents. It became associated with investments because in the early twentieth century, stock brokers would keep each client's share certificates in a separate 'Portfolio'. From there onwards, the word gradually came to mean any kind of collection of documents. In finance, it specifically means the investments held by an investor, generally all the investments that an investor has.

While any collection of investments can be called a portfolio, the concept is far more useful only if a portfolio has a defined goal and a time-frame. Hence for individuals, the best way to plan their investments is to have a separate portfolio for each financial goal. Not clear? Let us explain.

Portfolio Characteristics

Different mixes of funds, stocks and other asset classes lead to different risk levels and different gain (returns) expectations. Most people find it difficult to match these to their goals. However, if you think of specific financial targets (goals) and think of the money needed to achieve them, then you will be able to link risk and returns more precisely.

For example, you need money for your daughter's higher education after three years, you want to buy a house ten years before retirement, you want to go on a foreign vacation after two years, you want Rs.2 lakhs to be always available for emergencies, etc. Each of these goals are very finite. The risk you can take with each of them as well as the amount of money needed can be easily quantified. Therefore, it is relatively easy to decide the investments that should be made for each of these goals. These investments would thus form the respective portfolio for each goal. Mutual funds provide a convenient investment avenue for investors mainly due to its inherent characteristics like variety of funds across different asset classes, professional management and regulatory backing.



One must also note that a portfolio is not a random collection of financial assets. It has different parts that perform specific roles and complement each other. For example, a portfolio may have funds to provide gains and also to provide stability and protect the downside risk. Though in hindsight, it may appear that even one may have sufficed, it is important to think about all possibilities (positive and negative) and decide the type funds in the portfolio. Remember, the sole objective is to meet the goal within its timeline and nothing else. Hence goals may be typically met through a combination of mutual funds.

How to build a Portfolio Once your goals are listed out, it is relatively easy to build the respective portfolios. The first thing is to segregate goals as short term, medium term and long term goals. Typically, goals that need to be fulfilled in the short-term are fundamentally different from those that are for the long-term. Short term goals are typically less than 3 years away and best fulfilled using any fixed-income investments. This is because the asset class is relatively less volatile owing to which returns would be largely steady over this period.
For fulfilling long-term goals, you may look at a portfolio comprising of equity mutual funds. Equity is an asset class that has the potential to not only beat inflation but also provide relatively higher returns over the long run. However, equity mutual funds are

volatile in the short term and hence are suitable only for the long-term when volatility is evened out. Remember, in the short-term, the ups and downs of the stock market may even lead to temporary losses. Hence long term goals must generally have a more than 5- year time horizon.

This point is well illustrated in the accompanying graph. This graph traces the growth of an investment over ten years in two different asset classes – equity and debt. Equity is represented by the S&P BSE Sensex while debt is represented by the I-Sec Composite Gilt Index. It is clearly seen that though equity has been very volatile in the short term, it has provided much higher returns over the longer period of 10 years. Comparatively, debt has been less volatile but has provided mediocre returns over this period.

SUMMARY

A portfolio means a set of investments. However, the concept is far more useful only if a portfolio is linked to a defined goal and a timeframe. Hence it is useful to divide one's investments into separate portfolios, each associated with a specific goal rather than clubbing all investments into a single portfolio.

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