A BEGINNER'S GUIDE TO MUTUAL FUNDS

It is important to vary the allocation of equity funds based on time to goal

It is often observed that most investors track their investments very closely but often fail to monitor whether their goals are on track. The reason may be that investments have not been mapped to individual goals. A goal is defined as the purpose for which investments are made. A goal is also associated with a time-frame like a long term goal or a short term goal. Goals may be further segregated by priority as 'must have goals' and 'good to have goals'. The former mostly have a finite time-frame (like your child's higher education in 10 years, retirement in 20 years) while the latter (like a foreign vacation in 5 years) have a flexible timeframe and can even be excluded if needed.

THE RISK BASED APPROACH

Before we discuss the goal based approach, let us understand another approach that many investors follow. This is the 'risk based approach'. Herein an investor's investments are treated as a single portfolio and tuned as per his/ her perceived risk-tolerance or risk profile. The investor's risk profile is based on his attitude towards risk, determined mostly through a questionnaire which includes situational and life-style questions. For example, a risk-averse investor gets a 'conservative' risk profile while a risk taking investor gets an 'aggressive' risk profile. Intermittent profiles are called 'moderately conservative' and 'moderately aggressive'.

The investor's portfolio is constructed based on his/ her risk profile irrespective of goals. So a 'conservative' risk profile may have a marginal equity component while an 'aggressive' risk profile may have a very high equity component. In a risk based approach, goals are met by drawing from this common portfolio. Since you keep drawing from this pool, there is a chance that some goals that are 'good to have' but occur earlier in life (like a foreign vacation) may be easily met but those which are a 'must have' but come later in life (like retirement) may face a short-fall.

THE GOAL BASED APPROACH

A goal based approach to investing is thus more practical approach than a risk based approach as it closely tracks the progress of goals rather than only the investments. It also optimizes the allocation to asset classes based on the time frame of goals. For example, in the risk based approach, a conservative investor would have a low allocation to equity and high allocation to debt irrespective of goals. However, in the goal based approach, a long term goal would have a far higher allocation to equity vis-à-vis a short term goal. This is because the risk of equity is much lower if held for a longer term besides the potential for higher returns (see Chapter -Equity Fund for Long Term Goals). A lower equity allocation in the risk based approach would also mean that the investor needs to allocate more money to achieve long term goal sowing to comparatively lower potential returns from the larger debt portfolio. On the contrary, the goal based approach which has a higher equity component would need a lower cash flow for the same goals (as potential returns would be higher).

PORTFOLIOS TO SUIT GOAL TIME FRAMES
It is important to note that a goal may start as a long term goal and subsequently transform into a medium term goal with the passage of time before becoming a short term goal as it nears completion. For example, a goal for your child's higher education in 2024 is a long-term goal. But in 2020, it will be a medium term goal and in 2022 it will be a short-term goal. Therefore, the investment portfolio needs to change over the period of the goal to include less riskier assets as the goal nears. Here are a set of sample portfolios (by asset class) of varying risk levels and returns expectations based on time to goal.

1. **Aggressive Growth Portfolio** – Time Frame -> Above 7 years
A longer time-frame of 7 years or more can include a higher equity holding and within equity, smaller and medium sized companies.

Portfolio
80-90% - Equity Funds (a higher allocation to mid and small cap funds followed by large cap funds)
10-20% - Debt Funds (exact category may be decided by your professional financial distributor)

The portfolio is likely to face higher short term volatility but the long-term gains may more than compensate for the same.

2. **Growth Portfolio** – Time Frame -> 5 to 7 years
Here too a bulk of the portfolio is made up of equity funds. However, within equity, the portfolio will mainly include large cap equity funds followed by mid-cap equity funds.

Portfolio
80-90% - Equity Funds (Higher allocation to large-cap equity funds followed by mid-cap equity funds)
10-20% - Debt Funds (exact category may be decided by your professional financial distributor).

This portfolio too is likely to face higher short term volatility but the long-term gains may more than compensate for the same.

3. **Stable Growth Portfolio**-Time Frame -> 3 to 5 years
This portfolio may include a single category, viz., Equity-Oriented Hybrid Funds. These funds typically have over 65% equity allocation while the rest is fixed-income. The fixed-income exposure lowers the downside risk of the equity portfolio during volatile times. On the other hand, the rebalancing ensures that there is profit booking at regular

intervals if the equity markets are rising which in turn is shifted to fixed-income. Rebalancing also helps to buy more equity at a lower cost when the equity market falls. A 65% floor for equity also ensures that the fund is classified as an equity fund for Income Tax purposes. These funds are relatively less risky than pure equity funds.

Portfolio
100% Equity-Oriented Hybrid Fund
4. **Conservative Growth Portfolio** -Time Frame -> 1 to 3 years
For a goal of this time frame, it makes sense to invest in any fund which is majorly into debt. Closer to a one year horizon, the portfolio may be completely into debt while closer to a 3 year time frame the portfolio may include a marginal equity component like a debt oriented hybrid fund. The debt fund helps to avoid volatility as well as lowers the mark to market risk as a conservative growth portfolio looks at a greater degree of risk aversion.

Portfolio
Timeframe closer to 1 year - 100% Short Maturity Debt Funds
Timeframe closer to 3 years - 100% Debt Oriented Hybrid Funds

SUMMARY

There are two methods to construct a portfolio to meet goals. One, is the risk based approach which is based on the investor's attitude to risk called risk profile. A conservative risk profile would have a marginal allocation to equity in the portfolio while an aggressive risk profile would have a higher allocation to equity. The only drawback of this method is that one does not track goals but only tracks the investment portfolio. Funds to meet different goals are drawn from a common portfolio.

A more practical approach is the goal based investment approach which constructs a portfolio based on time to goal. A long term goal would have a higher equity component while a short term goal has a lower equity component. One also needs to rebalance portfolios and increase the debt component as the goal nears completion to reduce the mark to market risk.

NEXT TO COME: WHAT IS DEBT FUND?