A BEGINNER'S GUIDE TO MUTUAL FUNDS

The safety and stability of any equity portfolio may be enhanced by a proportion of investment in debt funds

Debt funds can play an important role in an equity portfolio. The exercise is called 'Asset Rebalancing' and may be executed periodically. While the concept is very powerful, it is mostly ignored in the world of investing. Nonetheless, it is quite easy to implement the same for a mutual fund investor. Asset rebalancing means having a target equity-to-debt ratio in your investments and periodically adjusting their allocation to ensure that this is maintained. Based on the time frame of your investments and how willing you are to take some risk, you may keep a certain percentage of your financial investments in equity and the rest in fixed income.

What this means is that if the actual balance (proportion) of an asset class in your portfolio has deviated from the desired proportion, you should shift investments from one asset class to another in order to revert to the original allocation. When equity is doing better than debt you may sell some equity investments and invest the redeemed value in fixed income and rebalance the portfolio. When equity is not performing well, you would sell some of your fixed income and move the money into equities. This implicitly achieves the basic idea of booking profits periodically in a relatively outperforming asset class and investing the proceeds in the relatively underperforming asset class. This may also help to lower your average purchase price in the latter. However, one must check for exit loads and applicable taxes before the rebalancing exercise.

The real benefit of this is seen only when the markets start falling and the value of the equity portfolio starts declining. Even though the equity part of this portfolio would fall when the market falls, the debt funds may help to cushion the fall. Investors typically get carried away by the well-performing asset class and ignore rebalancing in the greed to make higher profits. However, they lose out when the asset class cycle reverses. Let us look at two illustrations to understand this better.

ILLUSTRATION 1 – Both Equity and debt provide positive returns

	Equity	Debt	Equity	Debt	Remarks
Initial Amount Rs.	10,000	10,000	50%	50%	
Assumed Returns p.a.	15%	10%			12.50% combined returns
Amount after one year	11,500	11,000	51%	49%	
Rebalanced amount at the beginning of Year 2	11,250	11,250	50%	50%	Rs.250 transferred from equity to debt

ILLUSTRATION 2 – Equity provides negative returns					
Initial Amount Rs.	10,000	10,000	50%	50%	
Assumed Returns p.a.	-15%	10%			-2.50% combined returns
Amount after one year	999,789	11,000	44%	56%	
Rebalanced amount at the beginning of Year 2	9750	9750	50%	50%	Rs.1250 transferred from debt to equity

In illustration 1, Rs.10,000 each is invested in equity and debt with a pre-decided asset allocation of 50:50. The two asset classes return 15% and 10% respectively after one year. Hence the asset allocation after one year changes to 51:49 (equity:debt). In order to revert to the original 50:50 asset allocation, Rs.250 is transferred from equity to debt at the beginning of the 2nd year. Another way is to add Rs.500 to debt and make the amounts Rs.11,500 each.

In illustration 2, equity performs poorly and gives a negative 15% returns. The asset allocation after a year becomes 44:56 (equity:debt). To revert to the original 50:50 asset allocation, Rs.1250 is transferred from debt to equity. Another way is to add Rs.2500 to equity and make both Rs.11,000 each.

Thus debt helps you to cushion the negative returns of equity as debt is less volatile. Hence despite equity giving negative 15% returns in illustration 2, the portfolio returns were higher at negative 2.5%. Thus the safety and stability of any equity portfolio may be enhanced by debt funds.

While the above asset allocation needs to be re-balanced manually, there are a variety of hybrid funds which help you achieve asset rebalancing automatically by investing in a single fund. The most common are 'Balanced Funds' and 'Monthly Income Plans'. The former are equity oriented hybrid funds that typically invest over 65% of their portfolio in equity assets and the balance in debt. The latter are mostly debt oriented hybrid funds that usually invest upto 30% in equity assets and the rest in debt. These funds follow a periodic rebalancing cycle so as to ensure that the stated asset allocation is maintained.

Besides these, there are dynamic asset allocation funds which have larger asset allocation swings say from 0-100% in equity and 0-100% in debt. The asset allocation at any point of time is based on a model say a PE (Price to Earning ratio) model wherein a higher PE would mean a lower equity component (as valuations are high) and vice versa. Such funds either directly invest in equity and debt instruments or invest in equity and debt funds under a fund of funds structure. Whichever the hybrid fund, one must choose them based on investment horizon, risk appetite, exit loads as well as keeping taxability of returns in mind.

SUMMARY

While relatively lower returns may keep many non-risk averse retail investors away from debt funds, it is important to look at debt funds from an asset allocation perspective. By investing in two or more asset classes (also called diversification) including the less volatile fixed income, one ensures that any negative returns (if any) from more volatile asset classes are cushioned. Further, periodic rebalancing of asset classes helps investors to book regular profits in relatively outperforming asset classes and park the funds in relatively underperforming asset classes. There are a variety of mutual funds which provide automatic asset rebalancing through a single fund like balanced fund, monthly income plans and dynamic asset allocation funds.

NEXT TO COME: WHAT IS RETIREMENT PLANNING?