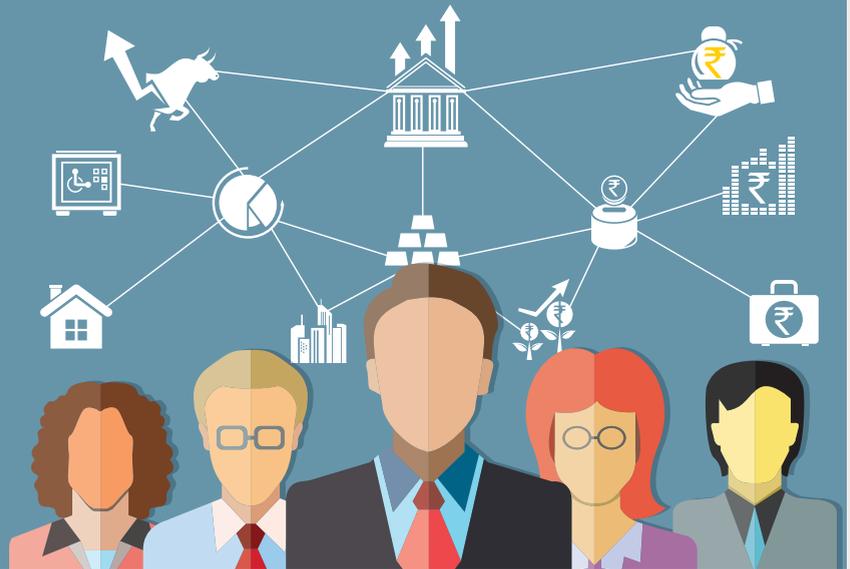


GET SMART WITH YOUR ASSET ALLOCATION

The ultimate use of your portfolio should shape your asset allocation.



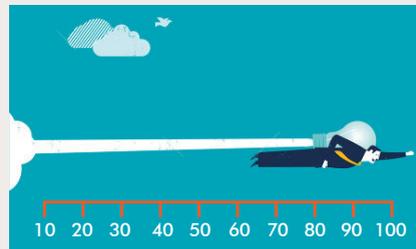
In 4 steps to creating a portfolio, we wrote about the need for asset allocation. It really is not surprising to note that asset allocation grabs the spotlight when designing a portfolio.

Any security-specific selection decision is preceded, either implicitly or explicitly, by an asset allocation decision. Asset allocation is therefore the most fundamental of investment decisions. It establishes the framework of an investor's portfolio and acts as a foundation on which a plan specifically identifying investments is based upon.

At this juncture, it would be wise to differentiate between asset allocation with diversification since investors tend to use the terms interchangeably. They pack their portfolio with a dozen funds and believe they have achieved both.

Differentiating between the two

Asset allocation is the process of determining the right mix of investments you should own. In other words, how much of exposure you need to have to various asset classes.



At the most fundamental level, they are equity, debt and cash. It can further be built up by looking at other asset classes such as gold, commodities, real estate, art, private equity, and collectibles.

Whatever your situation or life stage, having the right mix of investments is crucial and can increase returns and reduce risk.

On the other hand, diversification is what you invest in within these asset classes. For instance, you may decide to allocate 65% of your portfolio to equity. Figuring out how to invest your money within this asset class is where diversification comes into play. This would entail deciding on the number of equity mutual funds to hold; the mix between growth, value, infrastructure or other sector funds; how many large- and mid-cap funds; as well as whether or not to have an international fund to gain global equity exposure.



If you decide to go with just one equity fund, a 65% exposure to a single fund shows no diversification at all, despite the fact that you have planned a sensible asset allocation.

It's rather obvious now that the heavy lifting of any financial plan starts well before individual investment selection. In other words, sensible portfolio construction must commence with asset allocation. But do bear in mind that choosing an asset allocation model won't necessarily diversify



your portfolio. Whether or not your portfolio is diversified will depend on how you spread the money within each asset class.

Of course, the situation may be such that diversification has no place to play. A 24-year old on her first job might have the foresight to plan for retirement but not the financial bandwidth. She may be able to save just Rs 1,500 every month towards her retirement kitty. Her asset allocation could demand a pure equity exposure and she may invest the entire amount into one equity mid-cap fund. Her asset allocation is in place but diversification has taken a backseat.

Summing up, asset allocation maximises the risk-adjusted return and reduces risk by combining asset classes that have less than

perfect correlations. Diversification reduces the investment specific risk. Both are necessary to maintain a healthy portfolio.

Getting asset allocation right

The decision regarding the mix of assets to hold in your portfolio is a very individual one. A 62-year-old with limited investment assets and poor health who intends to retire next year will, very likely, need to invest differently than a wealthy entrepreneur with the same expected retirement date. Alternatively, two 45-year olds with identical income will also have a different asset mix if one intends retiring in 20 years and the other in five. Even if two individuals with the same income choose to retire at the same age, sources of in-retirement income, expected monthly expenses, expected length of retirement, and desire to leave a legacy for their children will play a role in a customised asset allocation.

No preset allocation or tool can possibly address the many variables that factor into



an appropriate asset-allocation framework. The asset allocation that works best for you at any given point in your life will depend on numerous factors such as age, time horizon for various goals, risk tolerance and capacity, and earning capability.

Moreover, your asset allocation would change over time. Your retirement portfolio in your 30s will look different from the same retirement portfolio when you are in your 50s.

Some financial experts believe that determining your asset allocation is the most important decision that you'll make with respect to your investments - that it's even more important than the individual investments you buy. Spend time figuring it out or take the help of a financial adviser when doing so.



Data Source: Morningstar

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