Rebalance away from equities and gold, in favour of debt

Undertaking this annual exercise will restore your portfolio's risk profile to its original level

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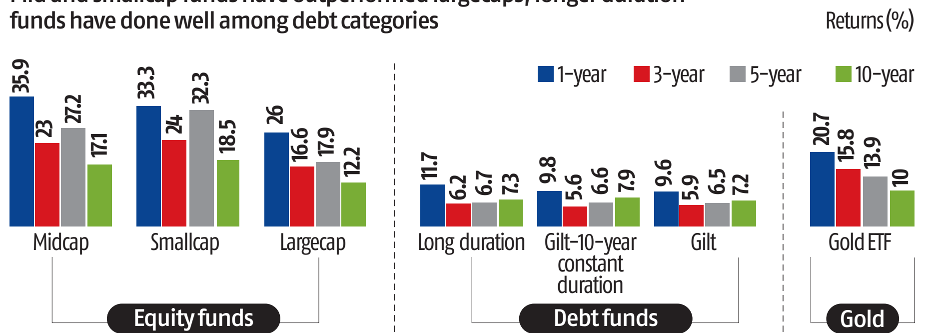
HIGH RETURNS ACROSS ASSET CLASSES OVER PAST YEAR

Mid and smallcap funds have outperformed largecaps; longer duration funds have done well among debt categories



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As 2024 draws to a close, many investors will approach their financial advisers for an annual portfolio review. Do-it-yourself investors should also conduct this exercise to eliminate the excess risk that may have accumulated in their portfolios over the past year.

Portfolios overweight on equities, gold

Many investors' equity exposure has exceeded their original strategic (long-term) allocation due to the strong performance of this asset class, both domestically and internationally, over the past year. Allocation to gold has also increased.

"Investors need to be mindful that such returns may not get repeated in the near future," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Investors whose original equity allocation stood at, say, 70 per cent, may now find it has increased to 80 or 85 per cent. "There is currently a temptation among investors to increase their long-term equity allocation to a higher level," says Arun Kumar, head of research, FundsIndia.

Investors have flocked to high-performing categories, like momentum funds. "Many investors have entered this category without understanding its nature and risks," says Bhavana Acharya, co-founder, Primeinvestor.in.

With debt funds losing their indexation benefit, investors have been looking for tax-friendly alternatives. "Many have substituted debt funds with balanced advantage funds and multi-asset allocation funds, believing they are exact substitutes, when they are not," says Acharya.

Rebalance towards debt

Check how your current asset allocation compares to your original allocation. If equity allocation has risen 5 percentage points or more beyond the original level, you must rebalance.

Besides equity funds and gold, debt funds, especially the longer-duration categories, have also delivered good returns due to a decline in bond yields. However, the absolute returns from equity and gold have been higher than from debt. "Rebalancing needs to happen away from equity and gold and towards debt," says Dhawan.

Rebalancing involves selling a portion of the outperforming asset class (or classes) and buying the underperforming one. "It allows investors to lock in returns from an asset class that has rallied," says Acharya.

Higher equity allocation can boost returns, but it also raises risk. "Equity funds can fall 40-50 per cent, or more, during a bad year. Striking a balance between desired returns and risk tolerance is why rebalancing in favour of debt funds is important, even if their post-tax returns are less attractive," says Kumar.

With growth slowing down, returns of equity funds could be adversely affected. "But a slowdown may lead to rate cuts, which will benefit debt funds," says Dhawan.

Which method works for you?

Besides selling a portion of the outperforming asset classes (equity and gold this year) and reinvesting in the underperforming one (debt), investors can also rebalance by directing incremental cash flows into the underperforming asset class. This approach helps avoid taxes and exit loads.

"Investors with cash flows can allocate money to fixed income. Retirees and others without income may need to sell equities and gold," says Kumar. Acharya says investors who have capital losses to set off may also sell an outperforming asset class.

The choice of method should also depend on the amount of incremental money available. "If it is insufficient to bring the allocation of debt back to the original level, investors should combine the two approaches," says Dhawan.

Reset sub-asset allocation

Within equities, investors may be overweight on mid and smallcap funds compared to largecap funds. In that case, they should reduce exposure to the former (where valuations are also higher) and raise exposure to the latter.

Sector-thematic funds: Only for seasoned investors

A large amount of money has flowed into sector and thematic funds. During bull runs, some of these funds tend to handily beat diversified equity funds. Most investors should not have any exposure to these funds at all or limit it to 10-15 per cent. "You need to time both entry into and exit from these funds perfectly, which is extremely hard to pull off," says Kumar.

Chasing past performance can be highly risky here. By the time an investor enters them, their high-performance phase may be behind them, and they could be ready to enter a downturn, which can be prolonged. Concentration risk is another concern: barely 5-10 stocks often account for 70-80 per cent of the portfolio.

Only highly experienced investors, who have the time and ability to do detailed analysis, should invest in these funds.

A few dos and don'ts

Avoid altering your strategic asset allocation during a bull market. "Asset allocation should change only if your goals, life situation, or risk profile have changed," says Kumar.

Do not blindly substitute debt funds with balanced advantage or multi-asset allocation funds. "Some funds in these categories can get very aggressive in their equity exposure. Investors must consider how such a substitution will affect their portfolio's risk profile," says Acharya.

Investors nearing a goal (one to three years away) should move investments from equities to debt to safeguard against a sudden market downturn.