mint

29-6-2017 page 15

POWER POINT

PRIYA SUNDER

We welcome your views and comments at
mintmoney@livemint.com

THE SECRET TO GETTING RICH IS QUITE ELEMENTARY

I am going to share with you my secret formula to getting rich. It's quite elementary, really. You only need to do two things—buy low, sell high. Yet, surprisingly, 90% of the investing community gets it wrong. That's because they invariably buy high and sell low.

The trick, of course, is to figure out when to buy and when to sell. How low is the lowest and how high is the highest? Once that is done, the rest is a piece of cake. Unfortunately, the collective wisdom of several investment gurus can't predict, with any degree of accuracy, the highest and lowest exit or entry points. No one predicted the stock market crash in 2008 and no one can predict when the next bull or bear run will occur. Which brings us back to the original issue—what's the magic formula for creating wealth?

Here is my real secret formula. Clean your ears well and wipe your glasses clean. And oh, shut the room door for good measure. You don't want to let everyone in on your secret. The real problem with the buy-low, sell-high strategy is the confusion around when to buy and when to sell. Here's where I introduce the concept of asset allocation, which in layman's terms denotes how much of each asset class you must own.

Each of us has an asset balance that is very specific to us. With respect to financial assets, one's ideal mix could be 70% in equity and 30% in debt, whereas someone else's may be a 30:70 equity:debt mix. The optimal mix is determined by an adviser who will come up with the right balance for you, based on your age, income growth, current assets, future goals, risk appetite, and income and expense patterns. This balance will help you achieve all your future goals comfortably, without jeopardising liquidity, stability or growth in your portfolio. If you don't have an adviser, then a general heuristic will suffice, though it won't be accurate. Hundred minus your age is the allocation to equity, and the rest is debt.

For simplicity, let's assume X's ideal asset allocation is a 50:50 equity-debt mix. Let's also say that X has an overall financial asset base of Rs20 lakh. We want to split this asset in the 50:50 ratio and rebalance each quarter in case the mix has skewed in either direction. We start by investing Rs10 lakh in equity and the remaining Rs10 lakh in debt. We are in June now and will rebalance this portfolio 3 months from now, in September. Let's also assume that we have a bull run between June and September and the markets soar. All figures indicated below are to illustrate a concept, and are not indicative of returns.

From June to September, the equity portfolio increases from Rs10 lakh to Rs12 lakh. The debt portfolio increases to Rs10.5 lakh. Quite obviously, X's portfolio is not in the 50:50 balance. The total value of the portfolio is Rs22.50 lakh and equity is nearly 53% of the portfolio, which is 3% more than where it should be. To bring the portfolio back to our recommended 50:50 balance, we move Rs75,000 from equity and reinvest in debt. Equity would now stand at Rs11.25 lakh and so would debt. The portfolio is now in balanced.

Now, let's assume we go through a bear market from September to December. The stock market plunges and the equity portfolio drops from Rs11.25 lakh to Rs9.25 lakh. Debt portfolio moves from Rs11.25 lakh to Rs11.75 lakh. Total value of the portfolio is Rs21 lakh and the portfolio is imbalanced. Equity forms 41% of the portfolio and debt 59%. In order to rebalance, X must sell Rs1.25 lakh worth of debt and reinvest in equity, so both asset classes stand at Rs10.5 lakh.

Notice that in the process of moving money from equity to debt (in a bull market) and from debt to equity (in a bear market), we are buying low and selling high. We sold when the markets were high, thereby booking profits, and bought when the markets were low, thereby buying value. In this process, we were guided by two principles. One, target asset allocation of 50:50, and two, discipline to rebalance each quarter.

COLUMN

Once we had pegged these two parameters, we achieved buy-low and sell-high. What we didn't achieve was buy when the price was the lowest or sell when the price was the highest. However, if we knew that answer, we would all be making money hand over fist.

The fact is that no one knows when the high is the highest and low is the lowest. All we can do is discipline our behaviour so we do what is best for our portfolio rather than trying to time the market. By timing the market, we behave like speculators, not investors. We give in to our baser instincts of greed (buying when the markets are high) or fear (selling when the markets are low). Both are harmful to the performance of our portfolios in the long run.

The above strategy is of course explained very simplistically. There are several factors to consider when buying or selling equity or debt, such as: taxation, exit loads, and underperforming funds. However, as a guiding principle, rebalancing through asset allocation is what we do for most of our clients each quarter.

There is beauty in simplicity. One becomes wealthy by doing some very basic, sensible things. Investors, in turn, must help themselves by shunning advisers who recommend get-rich-quick investments, tips or extravagant returns. There are no free lunches, and if you believe there are, then you may find too much on your plate that is unpalatable.

Priya Sunder is director and co-founder of PeakAlpha Investments.