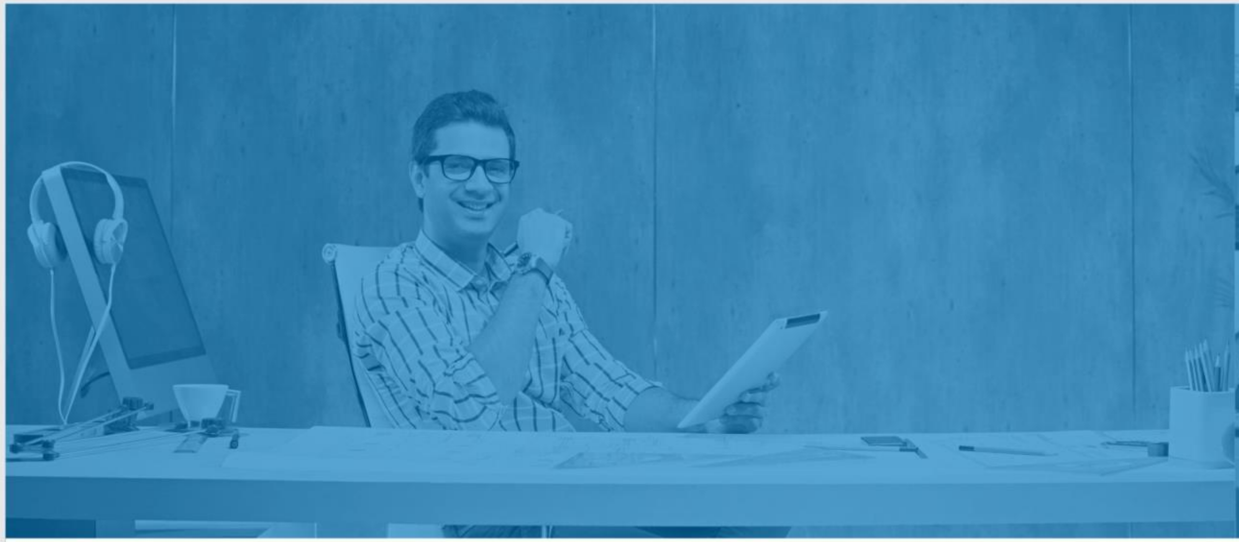
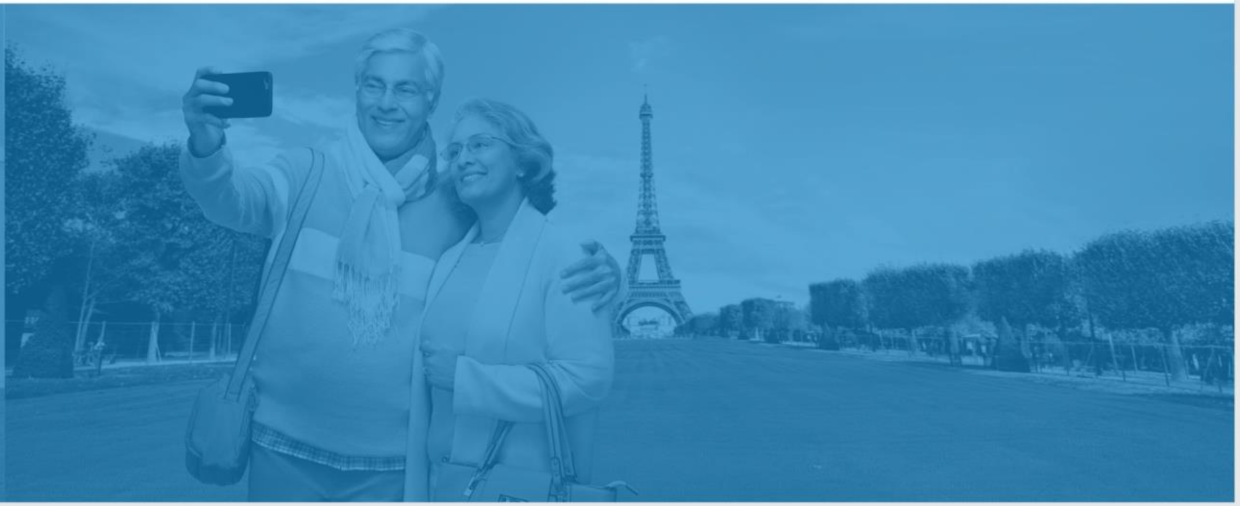


Lessons In Investing - Part 1

LIFE GOALS. **DONE.**

BAJAJ | Allianz



Importance of Asset Allocation

“The only investors who shouldn’t diversify are those who are right 100% of the time.” - Sir John Templeton

Different Asset Classes Outperform / Underperform in Different Years

Calendar Year-Wise Performance of Different Asset Classes (in %)										
CY 2007	CY 2008	CY 2009	CY 2010	CY 2011	CY 2012	CY 2013	CY 2014	CY 2015	CY 2016	CY 2017
Mid-Cap Equity (+71.8%)	Gold (+26.1%)	Mid-Cap Equity (+100.5%)	Gold (+23.2%)	Gold (+31.7%)	Mid-Cap Equity (+35.1%)	Cash (+9.0%)	Mid-Cap Equity (+46.1%)	Debt (+8.6%)	Debt (+12.9%)	Mid-Cap Equity (+51.3%)
Large-Cap Equity (+54.8%)	Debt (+9.1%)	Large-Cap Equity (+75.8%)	Large-Cap Equity (+17.9%)	Cash (+8.2%)	Large-Cap Equity (+27.7%)	Large-Cap Equity (+6.8%)	Large-Cap Equity (+31.4%)	Cash (+8.2%)	Gold (+11.3%)	Large-Cap Equity (+28.6%)
Gold (+16.4%)	Cash (+8.4%)	Gold (+24.2%)	Mid-Cap Equity (+10.4%)	Debt (+6.9%)	Gold (+12.3%)	Debt (+3.8%)	Debt (+14.3%)	Mid-Cap Equity (+1.5%)	Cash (+7.5%)	Cash (+6.7%)
Cash (+7.6%)	Large-Cap Equity (-51.8%)	Cash (+4.9%)	Cash (+5.1%)	Large-Cap Equity (-24.6%)	Debt (+9.4%)	Mid-Cap Equity (-2.8%)	Cash (+9.2%)	Large-Cap Equity (-4.1%)	Mid-Cap Equity (+7.2%)	Gold (+5.1%)
Debt (+7.0%)	Mid-Cap Equity (-65.4%)	Debt (+9.1%)	Debt (+5.0%)	Mid-Cap Equity (-39.9%)	Cash (+8.5%)	Gold (-4.5%)	Gold (-7.9%)	Gold (-6.6%)	Large-Cap Equity (+3.0%)	Debt (+4.7%)

Source: Bloomberg. Asset classes represented by the following indices: **Debt** (Crisil Composite Bond Index), **Cash** (Crisil Liquid Fund Index), **Large-Cap Equity** (Nifty 50 index), **Mid-Cap Equity** (Nifty Midcap 50 index), **Gold** (MCX Spot Gold index)

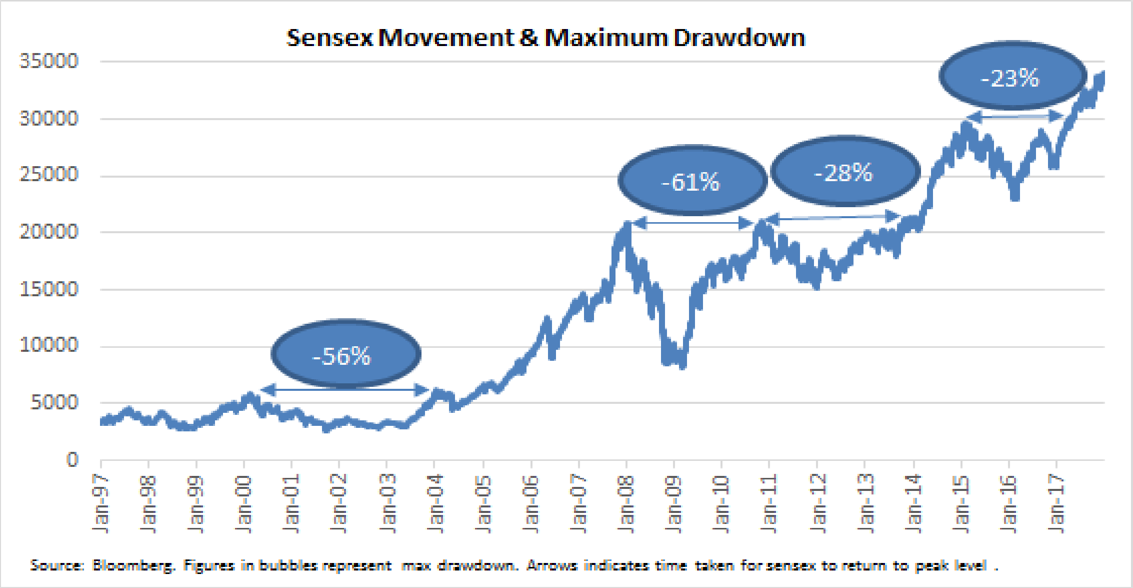
- Mid-cap equity and large-cap equity was the top performing asset class in CY 2007, but then became the bottom performing asset class (falling sharply) during the market downturn of 2008. Similarly equities did well in 2012, 2014 and 2017, but was the bottom performing asset class in 2011, and 2016.

- Gold as an asset class outperformed during the final crisis (in the years of 2008 to 2011), but was among the bottom performing asset class in 2013-2015.

- Debt outperformed in 2015 and 2016, but was an underperformer in 2017, as bond yields hardened during the year.

- Therefore, it would be wise to have a mix of different asset classes in your portfolio, and review your asset allocation from time to time.

Equities have generally outperformed over the long term; but they also come with large downside risk



- Equities (represented by the benchmark Sensex index) has performed well over the long term, but this also comes with regular market downturns, which last for some time.
- The Sensex has seen a maximum drawdown of 56% during the dotcom bubble crash of 2000, a max drawdown of 61% during the global financial crisis of 2008-09, and reasonably large drawdowns in 2013 and 2015 as well.
- Also, in each of these market downturns, it has typically taken the Sensex around 2-4 years to reach back to its previous peak level.

Correlation between different asset classes is quite low; thereby helping to diversify risk

	Equity	Debt	Gold	Cash
Equity	1			
Debt	0.13	1		
Gold	-0.13	0.71	1	
Cash	0.05	0.36	0.03	1

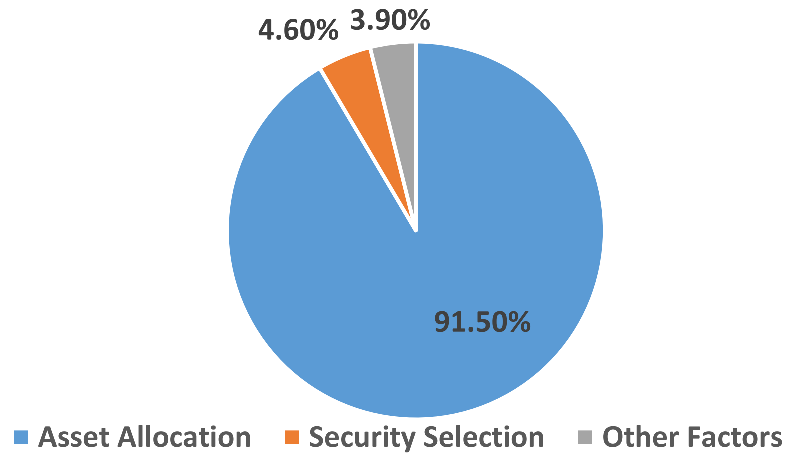
Source: Bloomberg, Crisil,. Correlation is calculated on daily returns over a 10 year period ended Feb 2018
Equity is represented by Nifty 50 index, **Debt** by Crisil Composite Bond Index, **Gold** by MCX Spot Gold index and **Cash** by Crisil Liquid Fund index

Correlation ranges from –1 to 1, with –1 indicating that the returns move perfectly opposite to one another, 0 indicating no relationship, and 1 indicating that the asset classes react exactly the same.

- **Low correlation between different asset classes helps to diversify risk and optimize risk and returns.**
- **Low and negative correlation may provide hedge against sharp downtrend in one asset class. For example: Equity & Gold has a negative correlation.**

Asset Allocation plays a key role in determining Variability of Returns in a portfolio

Determinants of Portfolio Performance – Variability in Portfolio Returns (%)



Source: *Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, Determinants of Portfolio Performance II: An Update, Financial Analysts Journal, May/Jun 1991*

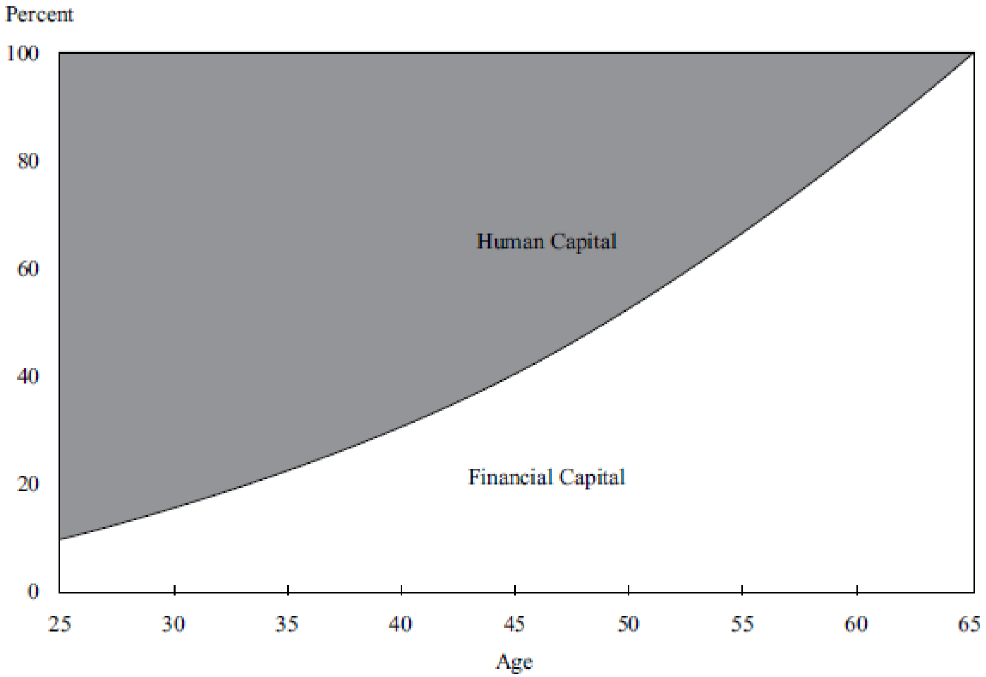
- In a landmark study published in 1986 by Brinson, Hood and Beebower, in their seminal paper titled "Determinants of Portfolio Performance" (popularly known as the BHB study), it said that **93.6% of a portfolio's variation in returns is explained by asset allocation.**

- In a update to the study in 1991, it was found that **Asset Allocation determined 91.5% of the portfolio's variability in returns,** followed by Security Selection (4.6%).

- However, there have been some critics to the study, and Xiong, Ibbotson, Idzorek, and Chen (2010) showed that **active management has about the same impact on performance as a fund's specific asset allocation policy. But nevertheless, asset allocation play a key role.**

Economic Balance Sheet: Human Capital & Financial Capital

Human Capital & Financial Capital Relative to Total Wealth



Source: CFA Institute, Introduction to Asset Allocation

Life-Cycle Investment Guide to Asset Allocation

Investor Age Range	Stocks	Real Estate	Bonds	Cash
20s	65%	10%	20%	5%
30s to 40s	55	10	30	5
50s	45	12	38	5
60+	25	15	50	10

Source: CFA Institute, Malkiel (2004)

- At younger age, human capital dominates the economic balance sheet, with most of the individual's working life ahead of him/her. Financial capital is lower at the initial stage due to lower earnings and savings.
- Also, the investment horizon is longer. These attributes allow higher risk taking ability for the investor, as he/she is not dependent on their investment for livelihood.
- At later stage in life (near retirement), financial capital would have grown substantially, while human capital would have diminished accordingly. Therefore, capital preservation becomes of paramount importance as investment horizon is limited.

Debt funds are considered relatively safe, but can be volatile at times, depending on the interest-rate environment & fund category

Performance of MF Debt Fund Categories - Yearwise in Cycles (%)								
10 year yield movement	+140 bps	-250 bps	+230 bps	-52 bps	+80 bps	-97 bps	-125 bps	+ 80 bps
Bond Yields (Rising / Falling)	Rising	Falling	Rising	Falling	Rising	Falling	Falling	Rising
MF Category	CY 2004	CY 2008	CY 2009	CY 2012	CY 2013	CY 2014	CY 2016	CY 2017
Intermediate & Long Term Bond	1.5	14.6	2.4	10.2	4.7	13.3	12.3	4.0
Short-Term Bond	3.3	11.4	5.8	9.6	7.8	10.1	9.6	5.8
Liquid Fund	4.5	8.7	5.0	9.4	8.9	8.8	7.3	6.2
Dynamic Bond	1.7	12.5	-0.7	10.2	5.7	14.0	13.0	3.5
Long Term Gilt	-0.5	29.8	-7.6	11.5	1.9	17.7	15.9	2.2

Source: Morningstar, Only Growth option & regular plans considered

- In years in which bond yields rise substantially, bond funds underperform and even deliver negative returns sometimes.
    - ✓ Within this, long term categories (like gilt & bond, dynamic bond) underperform more as they are more susceptible to interest rate movement (higher interest rate risk). Meanwhile, short term categories (like liquid, short term bond) relatively perform better as they are less susceptible to interest rate movement (lower interest rate risk).
- In years in which bond yields fall substantially, bond funds outperform and even deliver double-digit returns sometimes.
    - ✓ Within this, long term categories (like gilt & bond, dynamic bond) outperform more as they are more susceptible to interest rate movement. Meanwhile, short term categories (like liquid, short term bond) relatively underperform long term categories as they are less susceptible to interest rate movement.

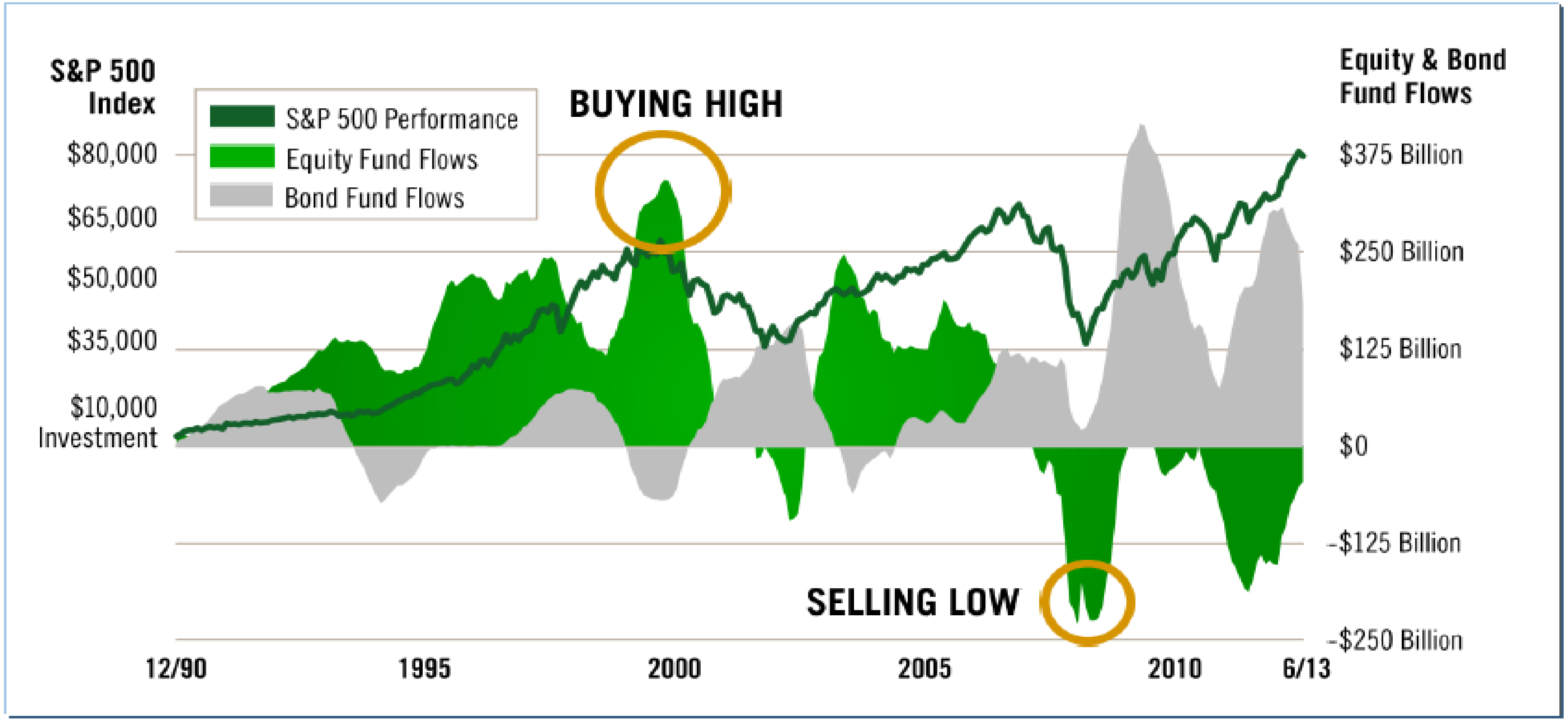
8

"Be Fearful When Others Are Greedy and Greedy When Others Are Fearful" - Warren Buffett

But that doesn't happen many times, as investor preferences get influenced by emotions

Investors sometimes tend to mistime in various asset classes, as they get influenced by emotions - **The Global Context**

S&P 500 Index Performance vs. Equity and Bond Fund Net Flows



Source: Franklin Templeton Academy: Equity Investing: Lessons from History.

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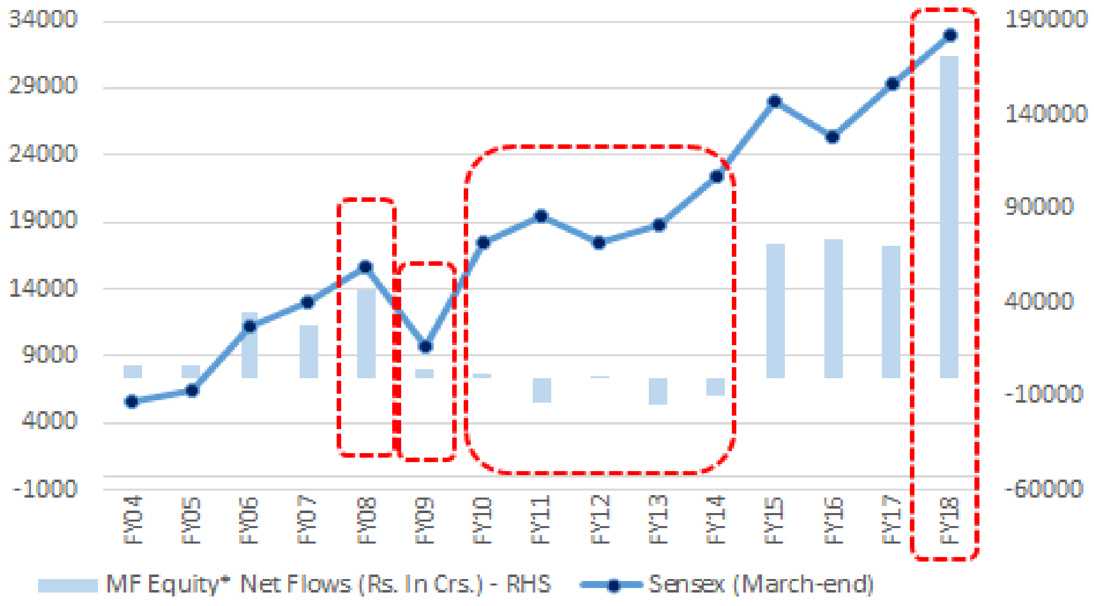
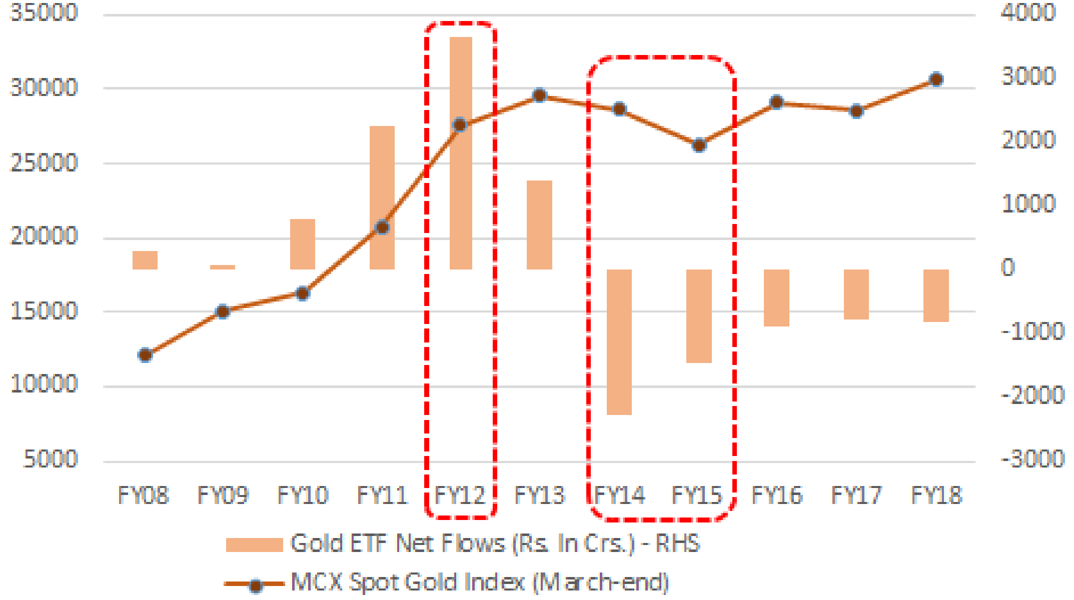
Investors sometimes tend to mistime in various asset classes, as they get influenced by emotions - **The Indian Context**

MF Equity Net Flows Vs. Sensex



Source: AMFI, Bloomberg. * Includes equity fund & ELSS

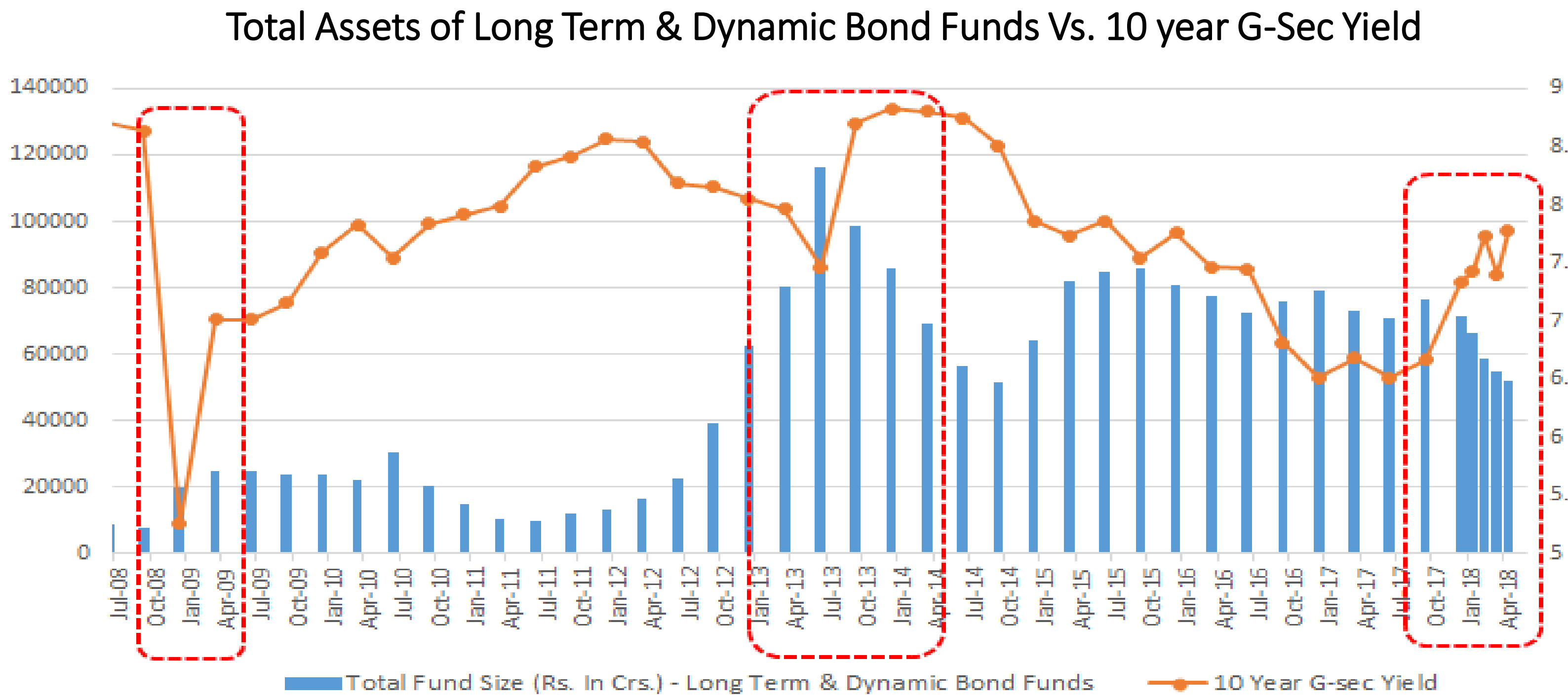
Gold ETF Net Flows Vs. MCX Spot Gold Index



Source: AMFI, Bloomberg

- In FY08 investors rushed into equity funds despite elevated market levels and valuations being rich. Meanwhile in FY09 investors hardly invested in equity funds despite attractive valuations.
- Between FY10 to FY14 equity funds registered net outflows, even as the markets kept rising. In FY18 equity funds registered record high inflows, as the Sensex also touched record high levels.
- Gold ETFs registered the highest inflows in FY12, when gold prices were elevated. They registered outflows in FY14 & FY15, even as gold prices fell.

Investors sometimes tend to mis-time in various asset classes, as they get influenced by emotions- **The Indian Context** (Contd..)



Source: AMFI, Bloomberg

- Long term bond funds saw large inflows in first half of CY 2013, when yields had fallen considerably. However investors were hurt as yields rose sharply after June 2013 on the back of Fed taper scare.
- Assets of long term bond funds grew in last quarter of 2008 as yields softened. However here too investors were hurt as yields rose sharply post Dec 2008.
- Since late 2017, bond yields have hardened substantially, hurting investors in long term bond funds. Long term bond funds started seeing outflows in the months of Jan-April 2018

Investor Sentiment during Market Cycles

Source: The Big Picture blog

THANK YOU

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