Vetri Subramaniam
MD & CEO
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Why the right asset allocation is personal

"What's the best allocation for me?"

I am sure there is a suitably complex mathematical model out there that can answer your question.

Harry Markowitz, the father of Modern Portfolio Theory, developed a mathematical framework for constructing investment portfolios that maximise expected returns for a given level of risk. His work demonstrated that diversification reduces overall portfolio risk.

He shared the Nobel Prize in economics in 1990 for his pioneering work on the mathematical underpinnings of diversification.

When author and Wall Street Journal columnist Jason Zweig asked Markowitz how he managed asset allocation in his portfolio, his reply was:
"I should have computed the historical covariances of the asset classes and drawn an efficient frontier. Instead, I visualized my grief if the stock market went way up and I wasn't in it—or if it went way down and I was completely in it. My intention was to minimize my future regret. So I split my contributions 50/50 between bonds and equities."

Markowitz's approach to asset allocation was a simple rule of thumb: minimise regret. Not a complex formula, but arguably fit for purpose, for him.

There is no one-size-fits-all solution for asset allocation. Personal finance is personal. It is not just a mathematical formula; it needs to have a personal anchor.

People need to understand their own temperament, flaws and goals. It does not matter whether you have read all the best texts on investing or imbibed the best ideas from the masters. It is not about how well you can read the economy, analyse the financials of a company or understand its moat.

Finance has a strong overlay of psychology and understanding yourself matters the most.

A mathematical model may help derive the most appropriate asset allocation to achieve your goals. But you may still need to adjust it for what lets you sleep well at night. If your exposure to the markets is keeping you up at night, it is likely not the right allocation for you.

Here is an interesting behavioural approach I have seen a wealth manager practise to address loss aversion by creating two reference portfolios.

The manager creates two portfolios for the client. The Growth Portfolio seeks to capture and beat the equity market on the upside. This is a 100% equity portfolio that carries higher risk and higher potential reward.

The Conservative Portfolio aims to preserve capital when equity markets are performing poorly. This portfolio is a mix of fixed income and hybrid schemes.

When equity markets are doing well, the manager discusses the Growth Portfolio with the investor. When the markets are down, he points to the resilience of the Conservative Portfolio. This is asset allocation and behaviour management rolled into one. It creates a behavioural anchor that helps the client sleep better at night.

Older users of mobile phones will remember the memory problem. The memory effect was a problem specific to older Nickel-Cadmium (NiCd) and Nickel-Metal Hydride (NiMH) batteries. If you partially charged those batteries without draining them first, they would "remember" the shortened cycle and gradually lose capacity.

Investors have a similar 'memory bank' issue.

Financial historian and author Peter Bernstein observed that investors have 'memory banks'—the market experience that accumulates in their hippocampi over their investing lives and moulds their investment strategies.

In 2024, I encountered investors who believed there was no reason to own anything other than equities, based on their recent experience. In recent days on X (formerly Twitter), I have seen posts extolling the virtues of fixed deposits over the past two years. This, too, is a 'memory bank' issue. The best way to guard against this is to have a financial plan with a target asset allocation and rebalance periodically back to it.

Everything else that dominates the conversation—currently the West Asia conflict, weak capital inflows and a weak rupee—are just conversation points. They are not your financial plan.

American baseball player and coach Yogi Berra famously said, **"In theory, there is no difference between theory and practice. In practice, there is."** It highlights the gap between what you *plan* on paper and the messy, unpredictable reality of actually executing that plan.

I do not underestimate the challenge in executing the plan. But as Mikel Arteta, Manager, Arsenal F.C. (that just became English Premier League champions), puts it: "Respect the process."

Authors' profile

Mr. Vetri Subramaniam is the Managing Director and Chief Executive Officer at UTI Asset Management Company Limited. He joined UTI AMC as Head of Equity in January 2017 and assumed the role of Chief Investment Officer from August 2021. Mr. Vetri has over three decades of work experience. Prior to joining UTI in January 2017, he was Chief Investment Officer at Invesco Asset Management Ltd. He was part of the start-up team at Invesco (then Religare Asset Management) in 2008 and helped establish the firm's proprietary investment process and the team. Mr. Vetri started his career at Kotak Mahindra in 1992 after passing out from IIM Bangalore with a PG Diploma in Management. His experience in equity markets & investment roles at various firms from 1994 includes Kotak Mahindra, SSKI & Motilal Oswal. He was also one of the founders of Sharekhan.com (now Mirae Asset Sharekhan) where he led the research & content team. He has also worked as an advisor to a UK Hedge Fund Boyer Allan on its equity investments in India during 2003-2007. He is a frequent contributor to the media and regularly speaks on investing and markets at various forums – including the media & educational institutions.

Sources: Bloomberg

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