

Basics of Investing

Let's understand the various asset classes available to us for investing. The instruments that are available invest in these assets in different proportions and by using various methods. However it is still important to know the asset class and in this regard, the following information would be useful:

It has been said and seen in various studies across countries and continents that over the long run, equities tend to deliver the best returns. The following graph puts this in perspective for India.

Cumulative Annualised Returns (1980- 2004)



You may note that this period excludes last 3 years and had the same been included it would have favoured equities further as the CAGR for Sensex itself turns out to be 19%+

Some people may argue that the graph excludes real estate, which is an important asset class. However till date we do not have a real estate index and depending on the area the values have gone up differently. Just to take Delhi's example, Panchsheel Enclave would have grown on almost 25% YOY over the last 25 years but the same cannot be said for Daryaganj. In terms of positives it is very easy to do a leveraged investment in real estate as home loans are

available quite easily but in terms of negatives it does not have the kind of liquidity that equities provide.

While the absolute relative returns may vary in different eras, a ten year or at most a twenty year period is all we usually need to look at to see the familiar ranking of returns emerge – equities first, real estate next, then bonds, then cash. It's not a random return. It's one that is driven by the risk and return tolerances built into the capital markets for each kind of instrument. It's predictable over the long term because it is enforced by arbitrage – if the return gets out of line, capital flows so as to push it back in line.

From the above information it is clear that one needs to build equity into the portfolio to enhance returns. However equities are considered risky so shouldn't one stay away from them? Let us look at the following facts

BSE Sensex has grown from 100 points in 1979 to close to 16,000 now. That's an average growth rate of close to 19% p.a. – returns that other investments could not easily match. Even if we consider the Sensex level of 6,679 on 03Jan2005, the growth rate is an impressive 17% +. However this growth did not happen overnight or in a regular manner. Every stock market investor remembers Harshad Mehta scam and Ketan Parekh scam, the South East Asia crisis and tech bubble boom and burst and not to forget, India on the brink of bankruptcy in 1990. In fact seven of these 26 year periods have seen negative returns, sometimes as bad as –32.4% and –22.1%. Each time the market drops, many investors panic and stray from their plan.

(Data Source: BSE and Fidelity)

There are no free lunches

I haven't as yet discovered a low-risk high return investment – which is what all of us want

The alternative then is to accept a degree of risk in your portfolio, for the quest of higher returns, over time

.....Peter Lynch

Great so should I invest everything into equities today?

Despite the above statement on acceptance of risk, it is equally important to manage risk and it can be done by

- **Diversification** – Don't put all your eggs in one basket
- **Put time on your side** – It is time in the market and not timing the market that determines your returns. Biggest market gains are often concentrated in short periods (can't afford to miss). Also, don't start calculating your returns daily, as some times great returns are possible in a short span of time which normally leads to the investor exiting from a good investment losing the opportunity to make greater returns. Did you know that some investments have given absolute returns of more than 1000% between 2001-2006 (eg SBI Magnum Contra Fund)? Thus it was possible to multiply your capital by more than 10 times in the last 5 years. However many investors tend to exit as soon as they make a return of 20%-50% on their portfolio. They missed on so much more!!!

Do you know that a person who had 100 shares of Infosys in 1993 and is holding them till date would have 12800 shares today i.e, his Infosys holding is worth more than INR 25 Million today!!!! This translates into an astounding return of almost 85% yoy.

Putting time on your side is not just about holding the investment if markets crash, it is also about resisting the temptation of exiting from it when you have made a decent return. How would you have felt today if you sold Infosys as soon as your investment of INR10,000 in 1993 doubled to INR 20,000? Remember, Einstein said that compounding is the eighth wonder of the world.

- **Investing systematically** – through the ups and downs – choosing the right approach to investing in equities.

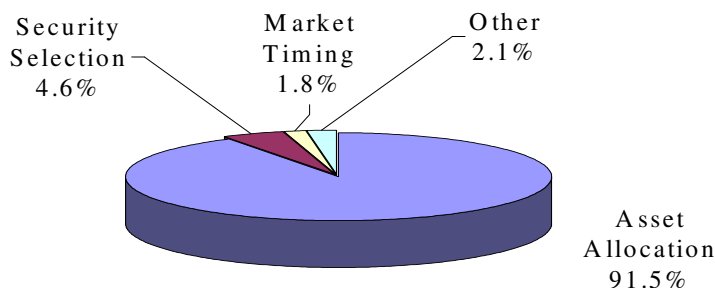
You could thus choose to invest a fixed amount regularly and benefit from Rupee Cost Averaging or alternatively you could choose Value Averaging as your method of investment.

Asset Allocation....key to your long term returns!!!

...and more importantly to a sound sleep

Asset allocation is the process of diversifying portfolio investments among several asset classes to reduce investment risk. Example 50% Equities, 30% Bonds and 20% Cash (Money Market Funds). The objective of asset allocation is to lower portfolio risk by reducing portfolio volatility. Loss in one investment may be offset by gains in another.

Determinants of Portfolio Performance



Source: "Determinants of Portfolio Performance II, An Update" by Gary Brinston, Brian D. Singer and Gilbert L. Beebower, Financial Analysts Journal May-June 1991. For illustrative purposes only. Not indicative of any specific investment.

Why Use Asset Allocation? To Increase Long Term Investment Results

Scenario #1: INR 100,000 invested at 8% over 25 years grows to INR 684,848
 Scenario #2: INR 100,000 divided equally among 5 investments (One loses principal and other 4 earn 0%, 5%, 10%, and 15% average annual returns).
Diversified portfolio will grow to INR 962,800 over the long term

Downside of Asset Allocation

A diversified portfolio MAY generate a lower rate of return when compared to a single "hot" asset class (e.g., growth stocks from 1995-99)

BUT

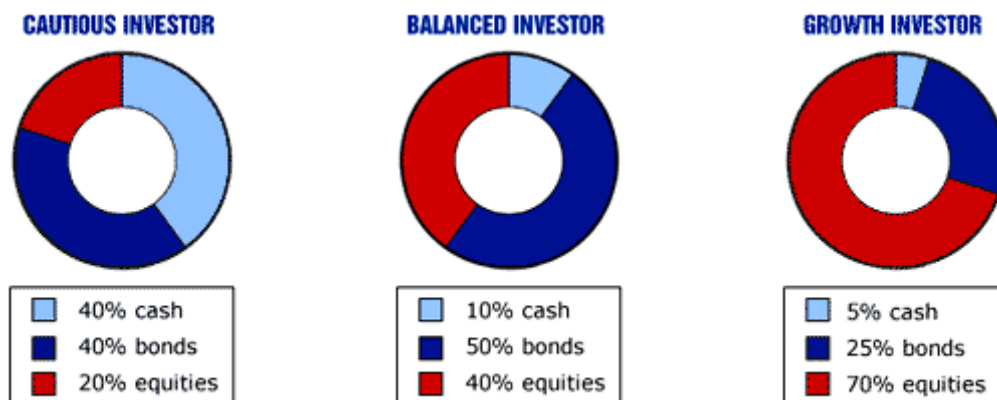
You never know the "hot" asset class in advance

Asset allocation attempts to reduce volatility and provide a competitive rate of return

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Standard Asset Allocation

A standard portfolio for different category of investors would look like this



Having seen the above information and of course there is more to it, we now need to decide our investment portfolio keeping the following factors in mind

Time Horizon – For how long you can have your money invested in equities before you need to dip into it for funding an important expense (e.g. marriage, retirement etc)

Attitude to losses – How do you think you would feel when your investments get hit 'temporarily' during a volatile twist of the market? Will you lose sleep?

Markets tend to move in cycles and what goes down is quite likely to come up again, but it could take some time. *If we have the right asset allocation, a downturn would not bother us too much and we would have the capacity to hold.*

In conclusion

Equities deliver the best return over the long run even-though they are volatile in the short run. The key is to figure out, how much volatility can you absorb and invest accordingly.