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Observations On Asset Allocation

Events of the last month provide significant lessons. We have been introspecting on what we could have done differently – and there will be a time to share that with you.

However, I want to share a few other observations with you today which are topical before the event passes and memories fade.

1. The only way to protect yourself from "tail risks" is through Asset Allocation.

A 100% Equity portfolio cannot protect you from tail risks. One needs cash buffers. Unfortunately, these cash buffers act as a drag on returns during normal conditions. And the unfortunate truth is that as Investing is becoming competitive sport, fund managers cannot hold cash buffers for long periods of time as they act as a drag on performance.

In our blog shared on 15 Dec 2019, we wrote – "We see two roles for "Debt" in any portfolio

- Yield – if the regular income is required to fund expenses.
- Optionality – if a debt instrument is liquid, it not only provides you a coupon, but also serves as a free Call Option to deploy additional capital in Equity markets/other Asset Classes if a very attractive opportunity came by. Most investors rue having no Cash to deploy during a crisis when Equities are available at very attractive valuations. Having access to Cash (ability to sell the Bond) + courage (ability to redeploy into Equities) are invaluable during a crisis"

2. In the short term, during a crisis, price movements across all Asset Classes are correlated

You may have observed during the initial week of the crisis, there was a sell-off in Gold before it recovered; Even liquid funds generated negative returns in a period of 2 weeks in March.

I can think of two reasons for this

- If you have leveraged positions, you sell what you can sell to meet margin calls. The most desperate seller sets the market price
- During a crisis, significant price dislocation happens. Our bond markets are witnessing this at the moment where last week paper was being placed at almost 150-200 bps higher than what it was at the end of February. This causes NAVs to be marked down.

This should normalize shortly post which Asset prices start moving on merit.

3. Beware the Inner Reptile

If you have had an urge to sell out of Equities in the last month, it is a perfectly rational response. Our brain has three parts. The "Hominid" layer controls rational thought. However, during a crisis the "Reptilian" part of the brain dominates to increases chances of survival. The enclosed 2 page pdf is a fascinating read.

This is why Investing is "simple, but not easy". Because it requires us to act against the natural survival instincts of the brain.

4. Your portfolio NAVs are not representative of true value, unless you are a desperate seller

The price dislocation shared above, is most acute in Small and Mid-Caps. This is because of a vicious cycle. At times like these, many MFs face redemptions, while inflows freeze. Algorithmic trading enhances selling pressure. And the need for fund managers to provide liquidity within a finite time window means no option but to Sell, even when the market has no liquidity. At the same time, Buyers wait for an even better price.

Prices being offered at present – as a broad generalisation – are reflecting prices being offered by desperate sellers and not their true worth. A revival of sentiment or a serious buyer can easily move their prices by 20-30% in a very short duration of time. And this dislocation/opportunity is the most acute in Small and Mid-Caps

This is the reason Solidarity asks you for a 5 year perspective. We believe the free float in our mid-cap choices should be significantly higher 5 years down the line and provide enough liquidity to get us an exit. In the interim, they provide very attractive buying opportunities.