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Home bias and the risk of not being diversified

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Dear Investors and Partners,

Diversification, the only free lunch in Finance – Harry Markowitz

The world witnessed an unwelcome geopolitical event this month that has escalated quickly and led to increased market volatility. However, Indian investors and advisors seem to be coping with this quite well, as over the years, the focus has been on getting the asset allocation and diversification right, rather than dwelling on events beyond their control. The ongoing conflict between Russia and Ukraine has once reiterated the importance of diversification.

Asset Allocation, as we know, is the practice of spreading one's investment across different major asset classes. The two objective of doing this is to have a control over both expected returns as well as the expected risk of the portfolio. This can be achieved by mixing uncorrelated asset classes in various combinations. Uncorrelated assets simply means having two assets which behave differently in same market conditions. For example, gold during war-like situations in the past has provided safe haven to investors whereas equities in general have declined. We can observe this low correlation between Gold and Equities in the recent phase also. Thus having Gold and Equities in a portfolio as per an investor's risk appetite, can be beneficial.

Diversification, on the other hand, is the practice of deciding allocation within a particular asset class, once you have set up your overall asset allocation, with an objective to further reduce the expected risk, while keeping the expected return within a range. For example, asset allocation may refer to investing in assets such as equities, debt and gold in various combinations. An equity-heavy portfolio can be expected to have a higher risk-reward characteristics than a debt-heavy portfolio. Diversification on the other hand, refers to allocation within an asset class, say within equities, largecap, midcap, smallcap or sector-wise say IT, Financials, etc. or style diversification like growth, value etc. The thing to keep in mind is that research has shown that diversification beyond a point doesn't reduce the risk any further and thus over-diversification can be avoided.

The same was reiterated this month as single country and single currency risk came to the fore. Russian currency Ruble dropped -52% between 28th Jan to 28th Feb and Russian stock market as indicated by MOEX Index dropped by -25% between 26th Jan to 28th Feb. In the same time period, MSCI All Country World Index delivered returns of -0.04% and MSCI Emerging market index declined by only -3.3%. Exposure to any single currency/country or even single theme, exposes investors to greater risk and leaves the portfolio vulnerable to such events.

This is an opportunity for investors and advisors to revisit their long-term portfolio allocation strategy towards internationally diversified funds. The well-known Home Bias of investors everywhere, can be looked into during this phase of the markets. Home Bias refers to the tendency to over-allocate to home market, because of familiarity and consideration of costs and taxation and added currency risk. However, Indian investors, through mutual fund feeder fund (FoF) route, can overcome such biases with ease. Investors can asset aside 10%-15% of their allocation to international fund to begin with and adjust it accordingly as per their profile and requirements. International Feeder FoF route, as you may be aware is currently under temporary suspension, as the limits for overseas investment are currently breaching the regulatory threshold. You can consider keeping in touch with your advisors to keep yourself updated as and when this route gets reopened. However, the point on diversification should be applicable to all aspects of investing and within domestic fund allocation also, one must diversify as far as possible. Investors can look for style diversification and perhaps look for schemes with low overlap with peers to achieve their objectives.

Stay safe & happy investing.

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