



# How to get the right portfolio

A portfolio plan should be designed around time frames that are longer than a business cycle. **Professor Arindam Banerjee** argues that while balance and diversity are important for a portfolio, overdoing it can lead to problems.

In February 2009, global investment bank Credit Suisse published a comprehensive survey of 17 major global stock exchanges roughly constituting 90 per cent of global market capitalisation. The study, entitled "Global Investment Returns Yearbook 2009", spans the last 109 years and comes with some fascinating findings.

After the current crisis started in late 2007, the global equity markets (represented by the MSCI World Index) lost 55 per cent of their value and declined by one-third in 2008. Major regional domestic markets, namely the Dubai Financial Market, have lost

around 70 per cent of their value in the last year. The Abu Dhabi Securities Exchange has lost half of its index value in the same period. Given the fact that equity as an asset class provides far superior returns compared to all other asset classes and comprises the major share in a typical high net worth portfolio, such findings raise serious concerns about equity investments, at least in the near term. After all, the global economic recovery is not going to be a perfect 'V'.

A typical high net worth portfolio comprises mainly equities, mutual funds, fixed-income securities and alternative

investments (including real assets) in order of preference. The order follows the risks associated with each asset class and the potential returns generated by them. Managing such traditional portfolios has never been as difficult as it is at the present time. The equity markets recently crashed to their all-time lows, while fixed-income securities outperformed equities for the first time. Alternative investments also remain volatile. In such turbulent times, it is critical to understand how one can rebuild one's portfolio and detoxify toxic components that have led to some of the significant capital erosion that we see today.



or overvalued. All these tasks are easier said than done, as these involve both investment skills and remaining loyal to investment discipline even in turbulent times.

### Equity

According to the Wall Street proverb, the time to buy equity is when there's blood in the streets. However, the equity markets presently provide an extremely divided opinion. Some consider the rally a dead cat bounce, meaning it will not recover in the near future, whereas others feel that the worst is over and that the market is readying itself for a new upswing. Since there isn't any school yet that teaches how to time markets, probing into some of the previous bear phases may provide some insights.

Post-1987 crash, the global markets got back to their previous highs after two years. During 1973–74, when the UK markets fell by 73 per cent in real terms, it took eight years for the All-Share Index to reach its previous high. It was not until 1949 that US markets rose to their previous pre-crash highs of 1929 in real, total return terms.

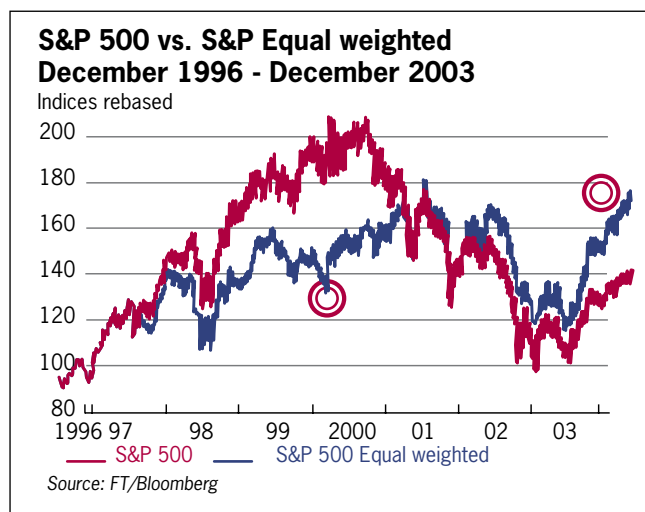
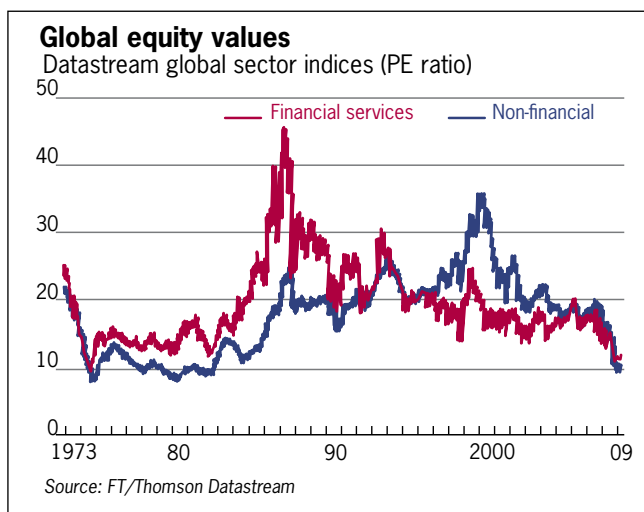
The Japanese markets, after their 1989 high twenty years ago, have since fallen 67 per cent and a recovery is not to be seen. These historical trends provide ample evidence that recovery of global equity markets to their previous levels is not foreseeable in the near future.

The obvious question, of course, is whether the equity markets offer any opportunity now. The answer is yes. The Credit Suisse report mentioned earlier reveals that since 1900, the global markets have generated a positive annualised real return in the range of three to six per cent. So, in the long run, equities are still the preferred avenue.

When markets bottom out, they provide plenty of opportunities for long-term investors to lay hands on stocks that are selling at a discount to their intrinsic value. These stocks are unfairly discounted by markets, rather than by a company's individual performance. The skill in identifying such stocks lies in seeking value. Stocks with sound fundamentals, sound business prospects, sustainable cash flows and low P/E multiples compared to industry P/E, low P/B ratios (stocks trading at a discount simply due to the systematic risk and not due to their performance), low enterprise multiples (EV/EBITDA), consistent records of high yields (your own basket of dogs of the Dow) and strong liquid positions offer good bargains.

One word of caution: all that trades at dirt cheap prices may never recover and may remain penny stocks, so one needs to take a closer look at a company's history and its financials before investing. One should avoid speculating and making quick money. One also needs to remember the old saying: "It is never wise to catch a falling knife."

Managing a portfolio typically involves taking three critical decisions. First, one decides on the long-term asset allocation. Second, one focuses on short- and medium-term deviations from the long-term asset allocations by identifying mispriced asset classes. Third, one looks for securities that are either undervalued



If stocks do offer value investments in recessionary times, the next intriguing question is where to invest and in which markets. Sectors such as healthcare and pharmaceuticals are traditionally considered recession-proof (or at least resilient), whereas utilities and FMCG sectors are considered defensive (sometimes due to comparatively high dividend yields). As such, these sectors provide good bargains during market downturns.

The emerging markets have the potential to rebound much faster than the developed ones, so keeping an eye on China and India may be a good idea. Some of the global picks could be Coca-Cola, Exxon Mobil, McDonald's, Procter & Gamble and Wal-Mart. Asian stocks such as Toyota Motor Corp. and Panasonic Corp. are value picks. By the same definition, DP World, Aramex, Air Arabia, Gulf Navigation and Taqa are value bargains on the domestic front.

If one observes the negative correlation between the dollar and the oil price, as well as the negative long-term sentiments on the dollar as a weakening currency, oil looks likely to close on a high by the end of the year. Holding a few oil stocks should therefore boost portfolio returns.

### Fixed-income securities

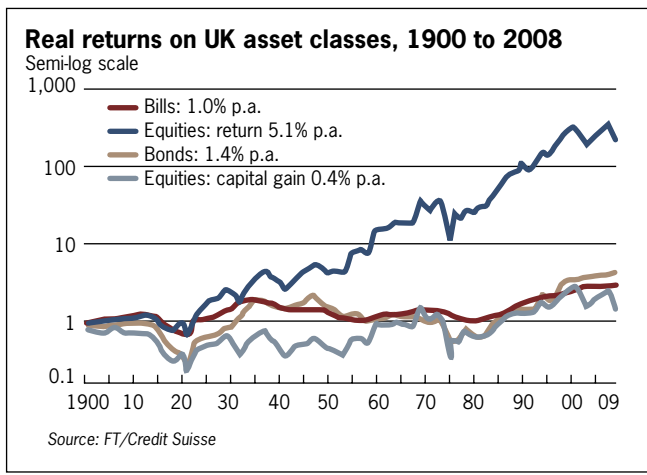
Fixed-income securities add much-needed safety to a portfolio and help capital preservation, which is the need of the hour. Bonds outperformed stocks in 2008 and remain a favoured asset class in these trying times. Plain vanilla bonds offer steady returns in a volatile market. For those seeking adventure, some hybrids can still become an integral part of a portfolio. The top of the list would be principal protected notes that provide capital protection and market-linked returns (if at all any).

Inflation-protected securities are another variant that offer inflation-adjusted capital protection. Treasury inflation protected securities are the most popular in this category. The only drawback with these securities is the lower coupon payments they offer. Emerging markets such as India even offer capital protection mutual funds that provide similar benefits to a retail investor. In essence, during a recession, credit risk increases. As such, fixed-income securities become an important asset class, thanks in many cases to their sovereign backing.

### Gold still a hot commodity

In the alternative asset class, everyone is upbeat about gold and there is every rational reason to be so. Historically, gold has proven to be the only asset class that has provided a significant hedge against inflation. In the present context, gold continues to rise, mainly due to fundamental factors that make it more attractive. The advent of gold ETFs and gold futures has made investment more accessible to the small investor. But is this the right time to buy gold? Yes. The supply of gold has not increased in recent times, while demand keeps on rising. The 2009 World Gold Council Report indicates that the Americans, Canadians, Swiss and Chinese are buying a lot more. Furthermore, not much is heard on new explorations.

Hedge funds are among the other alternatives. If not totally dead, hedge funds are seeking a breather in the intensive care unit. For now, let's not consider it a serious portfolio candidate. Private equity



exits have become a near impossibility these days because of the sudden fall in market valuation, but recessionary times provide good vintage years for new ventures. If one finds exciting ideas with great business potential at a discounted value (mainly due to the market conditions), investing in them would not be a bad idea.

Real estate investing is simply based on demand supply logic. But it will be mere foolishness to buy another Manhattan in Dubai. In other words, investment in real estate with the Dubai model in the backdrop would only make us lose money at the end of the day.

### Balance is important

We all admit that market bottoms cannot be predicted, so it is important to remain firm to an investment strategy. Equities are a volatile asset class. One has to realise that the probability of losing money is equal to the probability of gaining from the strategy. However, regular investment in a diversified portfolio helps in building wealth over time. Adding safety to a portfolio through purchasing bonds helps in capital preservation.

On the commodities front, we can all foresee prices of tangible commodities rising in their value, resulting from a fall in the US dollar value as predicted by global economists like Nouriel Roubini and George Soros. This circumstance works in favour of oil and gold. It is also necessary to keep a component of cash as contingency, but one should not allocate too much cash in the portfolio just going by the market sentiment "cash is king".

Finally, one should not simply churn the portfolio because of a downturn, recession or stock market hitting an all-time low, assuming that the bottom has arrived. A portfolio plan should be designed around time frames that are longer than a business cycle. It should be designed around the basic strategy based on balance and diversity, strictly following the investment discipline. Having a well-diversified portfolio is always advisable, but one should focus on numbers. As Warren Buffett observes: "If you have a harem of 40 women, you never get to know any of them very well." It simply becomes unmanageable.

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