PGIM
India Mutual Fund

When in Doubt, Diversify

Ajit Menon
CEO

August 2023

Dear Investors and Partners,

Ever since the popular research paper on asset allocation was published in 1986 (titled Determinants of Portfolio Performance, by Brinson, Hood and Beebower) the topic has led to intense debate, especially in the investment industry. The paper concluded that asset allocation explained 93.6% of the variation in a portfolio's return. In 1991, an update to this study was published which confirmed the findings of the original study and concluded that asset allocation explained 91.5% of returns variance. However, critics of the study pointed out that it focused only on the variability of the returns and not on return levels or relative performance.

In the year 2000, another famous study (titled Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance? By Ibbotson and Kaplan) expanded the scope of the earlier study. It concluded that asset allocation explained 90% of the variability of the returns, however, between funds, they found that only about 40% of the return variation between funds is due to asset allocation, while the balance was due to other factors, such as asset-class timing, style within asset classes, security selection and fees.

In simple terms, what does all of this mean from an advisor's or investor's perspective? Although asset allocation decisions are important, a static fixed asset allocation strategy is not the answer. An analytical asset allocation strategy is required, which can adapt to the changing market environment and also changing investor requirements as time goes by. Thus, diversification between low correlated asset classes, choice of fund manager, a combination of active and passive funds are all important considerations. Being in the market and staying invested at all times is also equally important to enjoy these benefits.

Having established the above, it is imperative to diversify within an asset class as well, because of the variability of the return. This can be evidenced by analyzing different style indices over a period of time within equities as an asset class. For e.g. if one looked at growth-oriented managers v/s value-oriented managers and analyzed their performance, it may be evident that both of them go through cycles. Depending on the country that you are analyzing, over the longer term, a particular strategy may outperform the other. For e.g. in an emerging economy like ours, perhaps growth stocks may tend to do better, whereas in developed and mature economies perhaps value stocks may tend to do better. Remember, these are just rules of thumb and consideration in favor of diversification between managers within the same asset class.

Coming to our funds at PGIM India and our style of managing funds: it is a confluence of growth and quality investing, with a final consideration given to the prevailing valuation. As per our back-testing, this approach in the last two decades has worked well in Indian markets, and although there have been phases of underperformance, growth-quality investing has always bounced back. One such phase of relative underperformance is currently underway as value-oriented stocks have done better. Markets have also been rewarding cyclical stocks, and liquidity has led to smaller cap companies doing better. However, we are hopeful that markets in the longer term will continue to reward growth-quality stocks based on fundamentals.

In conclusion, we know that as an advisor or investor, one would want all the funds in the portfolio to do equally well at all points of time, and that is a natural human tendency and bias. However, as studies above have proven, the cornerstone of pursuing asset allocation strategy in the first place, means that one expects that there will be variability of returns. Therefore, the prudent approach would be to not react to short-term fluctuations and phases of relative underperformance and not necessarily take portfolio action, and thus remove the underperformers from the overall portfolio too frequently and rush into investing all the money into the high performers.

Thank you for your continued trust and confidence in our investment management services. If you have any questions or concerns, please do not hesitate to reach out to the PGIM India team or our distributor partners.

Stay safe & happy investing.