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POWER POINT

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ARE YOU TAKING TOO MUCH EQUITY RISK?

If the NSE Nifty 50 index's price-to-earnings multiple were to crash to the lowest multiple, as seen in 2008, then the Nifty would crash by more than 50%. This possibility highlights why the most important personal asset allocation decision is the proportion of net worth that one invests in equity or its variant, real estate. The following is one simplified approach to tackle this very complex decision.

Let's consider two couples: couple W and couple X, where all four of them are 60 years old. Both couples have just retired and do not own any real estate. Both couples also have savings equal to 30 years of current expenses. Assuming that their post-tax real (i.e. net of inflation) average returns are zero, their savings are sufficient, but they do not have any buffer. Both couples decide not to follow the rule-of-thumb of investing 100 minus their age i.e. 40% in equity. This is because they realise if the market crashed by 50%, their net worth would reduce by 20%. Since they don't have any buffer, they would have to cut down their lifestyle by 20%. Tangibly, this would mean severe austerity such as eliminating most discretionary expenses such as travelling out of town.

Couple W are US citizens and residents, and their equity allocation should ideally be the lesser of their need, capacity and temperament for risk. Since they have no buffer, their capacity for risk is zero and their equity allocation should ideally be zero. They could invest almost their entire net worth in a combination of US Treasury Inflation-Protected Securities (TIPS) and life annuities.

Couple X are Indian citizens and residents, which makes the process relatively complex, as described below.

NEED FOR RISK

Since couple X have savings equal to 30 years of expenses, they do not need to take equity risk. Further, they decide that they don't like the trade-off that equity offers them of risking their essential needs in exchange for the hope of enabling some discretionary wants.

But since it is not possible to buy tax-efficient CPI inflation indexed bonds in India, couple X are subject to the risk of unexpected high inflation. Holding treasury bills, via an appropriate liquid fund, can mitigate high inflation. But world history indicates that it cannot mitigate the rare risk of very-high inflation or hyper-inflation. Couple X decide that they need a 25% domestic equity allocation, since it is better at partially mitigating this risk. X also decide that though international investments can mitigate this risk, it is logistically too complex for them.

CAPACITY FOR RISK

Couple X don't have any buffer. So their capacity for risk is zero which implies an equity allocation of zero.

TEMPERAMENT FOR RISK

Couple X did not have a material proportion and quantum of investments in equity in 2008. So, they don't really know whether they have the temperament to stay invested after a crash of 50%. Hence, X subjectively decide that they have the temperament for an equity allocation of only 20%. This implies that they are willing to run the risk of losing 10% of their net worth which would mean a 10% reduction in lifestyle. Tangibly, this would mean practising moderate austerity, like picking a lower-cost option for most discretionary expenses.

> Decide equity allocation based on your need, capacity and temperament for risk

COMBINING NEED, CAPACITY AND TEMPERAMENT FOR RISK

The lower of couple X's need, capacity and temperament for risk is zero i.e. an equity allocation of zero. But due to the nuances of the Indian context, X do a trade-off between these inputs and pick an equity allocation of 20%. X's deliberate decision to take a little more risk than their capacity for risk is much better than letting a crude rule-of-thumb set their equity allocation at 40%.

For a younger couple that is yet to retire, their invisible human capital asset would make this calculation more complicated. The high returns from equity over the last few years have tempted people to increase their allocation to it. The test of need, capacity and temperament may indicate that many people cannot really tolerate their allocation to equity and real estate. And it would be better to figure this out sooner rather than later.

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