

# Asset allocation model of BAFs must fit your needs

Check fund's performance in different market conditions to evaluate efficacy of model

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With both equity and debt markets turning volatile, experts are recommending balanced advantage funds (BAFs), also called dynamic asset allocation funds, to retail investors. One reason is that these funds have the ability to offer downside protection. Year-to-date, while the Nifty 50 Total Return Index has fallen 6.8 per cent, the BAFs category has declined 3.5 per cent. These are all-weather funds.

"Investors can put money into these funds, irrespective of market conditions," says Bhavesh Jain, fund manager, Edelweiss Mutual Fund. Despite being hybrid funds, they receive equity-like tax treatment.

## Two models

BAFs invest in a combination of equity, arbitrage, and fixed income. The funds in this category follow one of the two models for deciding on equity allocation.

A majority of the funds follow a counter-cyclical approach. They use valuation criteria, such as price-to-earnings, price-to-book value, or a combination of these valuation criteria, to decide on equity allocation. As valuations turn expensive, they reduce equity exposure, and vice versa.

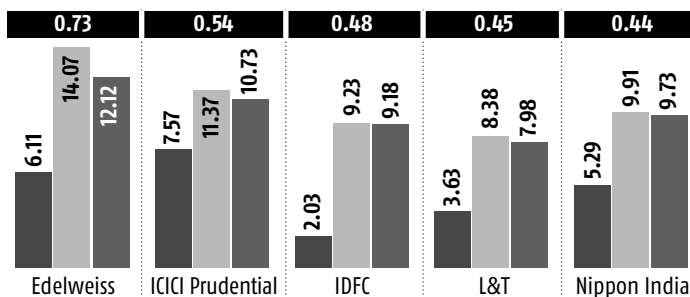
Some funds also follow a pro-cyclical approach.

"In our fund, we look at the underlying market trend. If the market is moving higher and showing strength, we increase equity exposure. If the market is falling and displaying weakness, we reduce equity exposure," says Jain. He adds that in 13 of the past 18 years, the market has shown strong trends, favouring a trend-following

## BAFs WITH HIGHEST RISK-ADJUSTED RETURNS

Balanced advantage fund

Returns ■ 1-year ■ 3 years ■ 5 years (%) ■ Sharpe ratio-5 year



Note: Returns are for direct, growth plans

Source: Morningstar AWS

model.

## Get benefit of asset allocation

All investors need to build diversified portfolios and follow an asset allocation suited to their risk profile. "Investors who can't create a diversified, asset-allocated portfolio, and rebalance it periodically may opt for these funds," says Kaustubh Belapurkar, director-manager research, Morningstar Investment Adviser India.

## Take limited exposure

Each of these funds will, however, have a standard model, which will translate into a certain range of allocation to equities. Each investor may, however, require a different portfolio mix. "One standard model and asset allocation range may not suit every investor," says Belapurkar. In BAFs, the net equity exposure could range from, say, 30 per cent to 70 per cent. An investor may not desire such wide variation in equity exposure. "A portfolio built using a single BAFs will offer downside protection. But this can work against you in a one-way market," observes Belapurkar.

He suggests an investor could take, say, a 20 per cent exposure to these funds. On this 20 per cent, if his equity exposure varies between 30 per cent and 80 per cent, at the portfolio level, his/her equity exposure will swing from 6-16 per cent. The rest of his/her portfolio

could be in pure equity and debt funds. While his/her equity allocation could vary in response to market conditions, and thereby curtail risk, such variation could be limited.

## Criteria for fund selection

Look at a fund's track record to understand the range within which its equity allocation has moved historically, and see whether this fits into your asset allocation requirement.

"Also check performance across different market conditions. This will reveal the efficacy of the fund's equity allocation model," says Belapurkar. According to Yogesh Kalwani, head-investments, InCred Wealth, "Investors should look for consistency of returns vis-à-vis peers in conjunction with alpha generated." Since these funds are targeted at conservative investors, they shouldn't take excessive risk. "On the equity side, they shouldn't take high exposure to mid- and small-cap stocks. On the fixed-income side, they shouldn't take either high credit or duration risk," says Belapurkar.

A good fund within this category should offer downside protection. "Look at the downside capture ratio, which measures a fund's participation vis-à-vis broader indices in the down markets. Select a fund with a lower downside capture ratio," says Kalwani. Go for a fund with at least a five-year track record (only 12 of 24 do).

Finally, avoid very small-sized funds.

