HDFC MF Musings

The Risk of Not Taking Adequate Risks.

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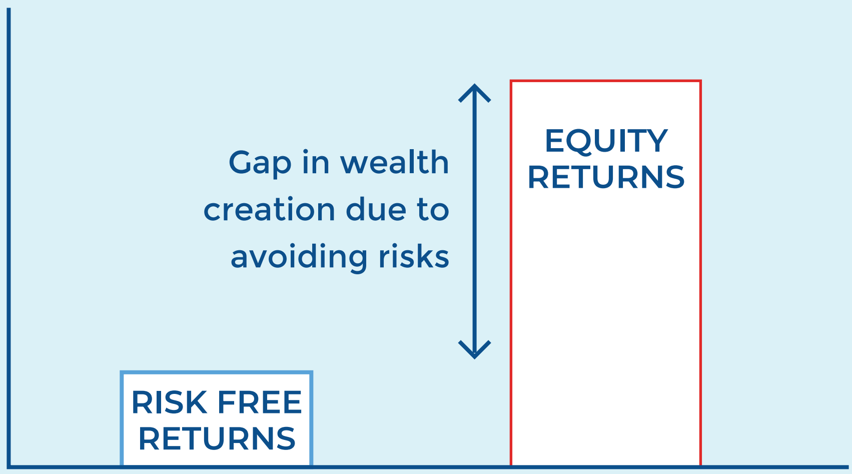


The above graph is for illustration purpose and may or may not be an exact representation of actual returns

As humans, avoiding uncertainties comes naturally to us. If there is a choice, we tend to cling on to certainties. Be it watching a cricket match heading for a close finish, or a thriller movie in which anything can happen in the end, we start getting anxious or biting our nails in such situations. While it is intuitive that uncertain situations put us into discomfort, they sometimes can be worse than even 'certain' unfavourable situations. Imagine you are traveling on road for a meeting and find that there is less than usual traffic and are likely to reach your destination ahead of time, you then tend to relax. On the other hand, if you get stuck in traffic, and are sure to be late for your meeting, chances are you still relax (though feeling bad about it) and may be think of excuses for being late. However, if there is moderate traffic and there is a 50 – 50 chance of being late, you are uncertain whether you will be late and the situation could put you in distress.

We are governed by this need for certainty in almost all aspects of our life and investing is no different. As far as possible, we try and avoid taking risks while choosing our asset classes. After all, it's the hard-earned money that we are putting in / investing. For this reason, many investors completely avoid equities!

Does the Mere Mentioning of the Word **“Risk”** Unsettle You?

There is a saying that goes - **A ship in the harbour is safe, but that is not what ships are built for**. Of course, the quote argues the importance of taking risks in life. However, when we imagine a ship, it is likely that we are reminded of the Titanic and its sinking. As we all know, the Titanic, despite its reputation as an unsinkable ship, the largest ever to have sailed the oceans at that time, built using the most advanced technologies of the period, did sink on its maiden voyage. Like in this example, our mind, often starts picturing the worst-case scenario when the word ‘risk’ is mentioned *(more on this later)*.

The same extends to investments. The moment equities are mentioned, some investors picture the worst-case scenario. Negative events that impacted markets like ‘Black Mondays’ and ‘Tragic Tuesdays’ are immediately remembered. Investors still remember the dot.com and subprime meltdown. For a long time, Indian investors have been predominantly choosing fixed income instruments. We invariably ask ‘Kitna Milega’. So often we have heard, ‘I am ok to get less as long it is certain.’ Risk avoidance while investing is very much prevalent in India.

The Risk of Not Taking Adequate Risks

Over-allocation to 'safer' investment avenues or completely avoiding equities could have its own downside. In other words, there are chances of missing out for clinging on to certainty. To understand the power of equities, we need to understand the power of compounding, which is purely mathematical. Let us observe the below table:

	Equity Fund	Fixed Income Fund
Initial Investment (In Rs)	100,000	100,000
No. of Years	25	25
Returns Per Annum*	12.42%	6.61%
End Value (In Rs)	18,66,764	4,95,392

*Mean of 10 years rolling return between 01/06/2014 and 31/05/2024 of Nifty 50 and CRISIL 10-year Gilt Index.

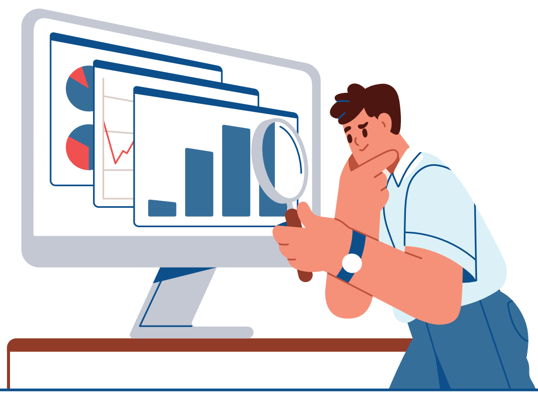
The 12.42% returns per annum in the above table represents Equities and 6.61% for Debt and the difference in end value is stark.

Past performance may or may not be sustained in future and is not a guarantee of future returns.

The key takeaways from this example are:

- **Equities are considered to be key ingredients of wealth creation in the long term.**
- **Whether we retire with a sufficient enough corpus depends not just on how much we earn during our working life, but also (probably more) how do we allocate among various asset classes.**
- **Most importantly, there could be risk in completely avoiding risks, i.e., the eventuality that we do not have enough corpus at retirement.**

Yes, fixed income instruments provide the comfort of knowing the end value of your investment after a period of 3 or 5 years, but this comfort comes along with an invisible price tag.



When Someone Mentions Ship, You are Probably Thinking of Titanic.

In real life, whenever we are faced with uncertainty, we tend to imagine the worst to happen. It is natural for first timers (including when it comes to investing) to overthink about things going wrong.

Not every ship's journey ends up like that of the Titanic. For any ship during its journey, it is sure to come across rough seas and ice bergs from time to time, and the occasional tsunamis too. For the captain of the ship, the crew and even regular sailors, these are part and parcel of the whole experience. For first time travellers though, the ups and downs of even mild waves can cause sea sickness. A moving boat or a ship competes against the human body's natural requirement for 'balance', resulting in dizziness, nausea, etc.

Similarly, people who have never been equity investors, the whole experience of watching their valued investments going down is unlikely to be a pleasant one. Not that it's pleasant for experienced investors, but their minds get trained to remain patient over time. However, the first-time investors are more likely to panic and commit an emotional mistake of exiting the investment (only to watch stock prices go up at a later date).

Sailing experts say that first timers usually experience discomfort only during the first few days at sea and slowly they get used to it. Same is true for equity investing as over the years you become used the movements in stock prices and stop reacting to them. Sea travellers who are sensitive to motion are also recommended to take enough breaks in between. This is akin to controlling your exposure to equities and investing gradually through SIPs.

SIP- Systematic Investment Plan

What about Tsunamis

When a tsunami or a rogue wave strikes, a ship in middle of an ocean on course of a long journey is much safer than one which is does short trips in and around the coast. When the situation gets back to normal, the vessel that is in for the long haul is more likely to be still floating. For metaphorical simplicity, we equate Tsunamis to the unpredictable events with potentially severe consequences that impact markets and the ships with longer routes to the investors who stay invested for a longer time. If we take a closer look into history, we have many such instances.

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Some of the events that impacted the markets over the last 28 years are listed below:

Year	Key Market events
1997	Asian Currency Crisis
1998	Pokhran Nuclear Test, US Sanctions
1999	Kargil War, NDA forms Central Government
2000	Dot Com Bubble
2001	9/11 Terror Attacks in US
2004	NDA loses Lok Sabha elections.
2008	Collapse of Lehman Brothers, Global Financial Crisis
2009	Ruling UPA re-elected in India, Satyam Scam
2010	European Sovereign Debt Crisis
2011	USA's Credit Rating downgraded
2013	Taper Tantrum (Surge in US Yields), High Twin deficit in India (CAD and Fiscal Deficit)
2014	NDA forms Central Government
2016	Demonetisation, Brexit
2017	GST Rollout
2018	Trade War, Surge in Crude Oil Price
2019	NDA forms Central Government
2020	Covid-19
2021	Union Budget & Omicron
2022	Russia - Ukraine War
2023	Rate Hikes and inflation, Israel - Hamas War
2024	NDA forms Central Government

If history is any indication, there can be more of such events to come in future too. Fortunately for us, there are ways to shield from the impact of these uncertain events. For a long-term mutual fund investor who chooses to invest systematically in the equity markets over a period, these events have proven to be irrelevant. So, the steps for tiding over stock market volatility could be:

Diversify your portfolio with mutual funds

Think long term

Start your SIPs and stick with them

Tsunamis come and go; the long-haul ships remain!

How much equity is good enough

While there are no scientific answers to the question as how much would be the optimal allocation to equities in an investor's portfolio, it mainly depends on the below factors amongst others:

- Age (Younger investors can have marginally higher exposure to volatile assets like equity)
- Income Profile (Salary receiving investors have more predictable incomes, hence relatively higher exposure to equity)
- Capital Base (Higher the capital base, higher the risk-taking ability)
- Investor psyche (This is more individual specific. Some investors naturally have higher tendency to take risks).

The last one out of these is the most interesting one. While it is a basic human tendency to avoid uncertainty, each one of us can have varying appetite of risk. Here the question in front of us is that, how much of our wealth We can see Temporary erode in a short period of time (say, a week, a month or 6 months), and yet can enjoy a peaceful night of sleep? The good part about stock prices is that, they are relatively more stable from a long-term perspective. In other words, the chances of losing money from stocks decreases with diversification and a long-term approach.

But one has to remember that avoiding risks completely can have potential towards achieving the ultimate objective of wealth creation.

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