# How to create a perfect MF portfolio

## An ideal portfolio is always based on suitable asset allocation, derived from one's risk appetite and investment horizon

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| | Low risk appetite | Moderate risk appetite | High risk appetite |
|---|---|---|---|
| Short-term (1-3 years) | EQUITY (10%)<br>Midcap and smallcap Funds (0%)<br>Largecap funds (0%)<br>Diversified funds (10%) | EQUITY (30%)<br>Midcap and smallcap funds (0%)<br>Largecap funds (10%)<br>Diversified funds (20%) | EQUITY (30%)<br>Midcap and smallcap funds (10%)<br>Largecap funds (10%)<br>Diversified funds (10%) |
| | DEBT (90%)<br>Medium and long-term debt funds (20%)<br>Short-term debt & liquid funds (70%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt & liquid funds (40%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt & liquid funds (40%) |
| Medium-term (4-7 years) | EQUITY (20%)<br>Midcap and smallcap funds (0%)<br>Largecap funds (10%)<br>Diversified funds (10%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt & liquid funds (40%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt & liquid funds (40%) |
| | EQUITY (20%)<br>Midcap and smallcap funds (0%)<br>Largecap funds (10%)<br>Diversified funds (10%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt and liquid funds (40%) | DEBT (70%)<br>Medium and long-term debt funds (30%)<br>Short-term debt & liquid funds (40%) |
| Long-term (over 7 years) | EQUITY (30%)<br>Midcap and smallcap funds (5%)<br>Largecap funds (10%)<br>Diversified funds (15%) | EQUITY (60%)<br>Midcap and smallcap funds (20%)<br>Largecap funds (20%)<br>Diversified funds (20%) | EQUITY (70%)<br>Midcap and smallcap funds (30%)<br>Largecap funds (20%)<br>Diversified funds (20%) |
| | DEBT (70%)<br>Medium and long-term debt funds (40%)<br>Short-term debt & liquid funds (30%) | DEBT (40%)<br>Medium and long-term debt funds (20%)<br>Short-term debt & liquid funds (20%) | DEBT (30%)<br>Medium and long-term debt funds (20%)<br>Short-term debt & liquid funds (10%) |

A PERFECT mutual fund portfolio is one that is in line with one's risk appetite and capable of meeting the financial goals. An investor in the equity markets, who takes the MF route, has to acknowledge that volatility is part and parcel of the markets and it's near impossible to avoid volatility. The focus should, therefore, be on learning ways to navigate markets during periods of heightened volatility.

The first step towards creating a MF portfolio is the identification of one's risk tolerance. Identification of risk appetite is important because it drives the decision-making process pertaining to asset allocation and the quantum of allocation in each asset class. Although, risk appetite varies from person to person and is also dependent on the life stage of the investor, it's advisable to take higher risk starting early on in one's career because as life progresses and individuals take on more responsibilities the ability to take risk decreases.

Once one has identified risk tolerance, the next step is to identify financial goals. Financial goals should have a time horizon assigned to them. Also, goals should be categorised into short-, medium- and long-term objectives. Short-term goals should have the time horizon of one-three years; medium-term four-seven years and long-term over seven years.

Goal-based asset allocation: The smartest way to create a goal-based portfolio is to separate portfolio for each financial goal or club similar goals based on risk profile and duration, and create portfolio for them. For example, one can club retirement, child's higher education in one portfolio, and buying a car or future foreign trips in another portfolio.

Asset allocation strategies are dependent on the time horizon of financial goals. To realise short-term goals, one need's predictable cash flows. Thus, for shorter duration portfolios a higher component of debt instruments are necessary. Similarly, for medium-term goals the portfolio should have a healthy mix of both equity and debt instruments and for longer-term goals higher component of equity.

After zeroing on the asset allocation for all the targets, the next step is to pick the MF category that is capable of meeting financial goals. Here, one's risk tolerance becomes important as within MF schemes, which include both equity and debt, the specified risk varies. In debt MFs there are various categories, like a gilt fund mostly invests in government securities and therefore is inherently safe, whereas income funds invest in corporate debt that is riskier. Within the equity-oriented funds, there is a wide range of schemes that cater to various risk appetites. A small-cap equity fund can deliver higher returns in comparison with a large-cap diversified fund. But the later is riskier and returns are volatile. On the other end of the spectrum are index funds that track benchmark indices and are therefore stable and tend to be less volatile.

Selection of MFs: Once the required MF categories have been identified in both equity and debt-oriented MFs, the next step is to choose the right schemes within a particular MF category. The selection criterion for a MF scheme should hinge on the investment objective and consistency of returns that a MF has been able to deliver. Efforts should be made to pick funds with larger AUM's and with reputed brand names, the track record and the longevity of the fund manager at a particular asset management company (AMC) is also important. Total expense ratio is another important criterion that impacts the choice between similar MF schemes. A fund with lower expense ratio is always better than funds with higher expenses ratio, as expense ratio can eat into the funds return in the hands of investors.

A Sample MF portfolio: The following table presents goal-based MF portfolios for varying degrees of risk appetite. A low risk appetite short-term portfolio has a debt component of up to 90 per cent and a minimal equity exposure; on the other end of the spectrum a high-risk long-term portfolio has an equity exposure of 70 per cent and within the equity MFs the exposure to mid-cap and small-cap fund is 30 per cent. The asset allocation strategy captured in the table can be a starting point for investors for further research.

Precautions: Based on one's financial goals he/she would need to invest in both equity and debt MFs and would also have to pick several MF schemes. But it should be remembered that finalising the portfolio with too many funds is a bad idea as beyond a certain limit, for example maximum 6-8 schemes, there is no benefit. Diversification plays an important part in risk mitigation. But after a certain point over diversification leads to lower returns and the tracking and monitoring and rebalancing becomes tedious for a person to manage. He/she runs the risk of loosing track and getting side-tracked from the original investment thesis if the there are too many components to an individual MF portfolio.

Finally, building a perfect portfolio is always based on suitable asset allocation that is derived from one's risk appetite and investment horizon. For that the most essential thing is clarity of goals and realism around one's cash flows. One has to be clear about what he wants to achieve, how much funds he needs for this and when he requires this. The perfect way of long-term investment is continuous asset allocation focused on goal-based portfolio creation. Each goal should be precise, defined in quantitative terms and duration.

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