

# How to determine asset allocation in dynamic asset allocation funds?

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Premium

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Dynamic asset allocation funds (DAAF) or balanced advance funds (BAF) are hybrid funds which alter their asset allocation between stocks and bonds as per the market conditions. The goal is to cut down portfolio volatility and help the investors achieve their financial goals.

Creating wealth or generating returns through DAAF or BAF is driven by a range of macroeconomic forces. For example, while both demographic forces and productivity growth could be responsible for the secular trend in growth, each could have potentially very different implications on monetary policies. Fundamentally, country's economic strength, monetary policies and geopolitical issues are the key drivers of the financial markets.

DAAF must be in sync with the dynamic nature of these factors. Fundamental parameters such as demography, fiscal deficit, forex reserve, inflation, trade deficit, geopolitical uncertainty etc. build the fundamental economic framework of the country. Interest rates are representative of these fundamental parameters. In developed countries, we see lower interest rates due to less volatility in fundamentals while in emerging and underdeveloped countries, we see higher interest rates due to higher volatility in fundamentals. For instance, Zimbabwe's central bank raised interest rates to 200% in June 2022 to prioritize economic stability.

Interest rates are major parameters which define the value of most of the asset classes including equities. Higher interest rates indicate higher opportunity cost resulting in lower valuation and vice-versa. Hence, a dynamic asset allocation strategy should factor in interest rates as the key deciding factor. Within the all-asset classes, equity returns are also dependent on the future earnings growth.

The dynamic band for equity allocation is necessary to accommodate the change in interest rate scenarios. A higher PE at lower interest rates is like a lower PE at higher interest rates. Due to the dynamic nature of the band, same equity allocation should be done for scenarios when interest rates were low, PE was high and corresponding scenario when interest rates were high, PE was low.

Thus, a combination of interest rates, valuation and future earnings growth should become an important parameter for determining the asset allocation in DAAF. In addition, there are two asset allocation models prevalent in the mutual fund industry – counter cyclical model and pro-cyclical model. Counter cyclical model follows the buy-low-sell-high formula whereas the pro cyclical model takes a different view altogether and increases equity allocation in rising markets and decreases equity allocation in falling markets.

Having said that, it's advisable to consult an expert and authorised financial advisor before investing as mutual funds investment depends on investors' risk tolerance, investment horizons and investment goals.

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