Investment Strategy

A wake-up call

Even a portfolio of mutual fund schemes needs to be revised periodically to maximise returns

Mutual fund is an ideal option for retail investors who need some exposure to the equity markets but either do not have the time to manage their own portfolio of stocks or do not understand much about investing in equity markets. Choosing a mutual fund is not sufficient to get the maximum benefit from investment. Reviewing the funds in the portfolia and taking remedial action is equally important.

Equity mutual fund investors should look out for signs that suggest a churn in their portfolio. Is any of the funds consistently underperforming its benchmark and that, too, with a wide margin? Minor underperformance may be ignored if the fund has a reputation of beating the benchmark regularly.

Also, if the investment objective of the fund is not matching with the financial objective of the investor, it is time for a churn. For instance, if an investor has a low-risk appetite and his fund is overweight on mid-cap stocks. Burgeoning assets under management (AUM) of a fund may also be a negative sign. AUM of better performing funds tend to rise at a brisk pace as many investors chase such funds. In such a scenario, the fund manager gets lot of money to manage, which is difficult as large-scale entry or exit can destabilise a stock's price, specially if it is not very liquid. Thus, the fund manager's universe narrows down to liquid medium-cap stocks with a potential to grow into large caps. Thus, if a fund is unable to perform with a rise in AUM, then investors can opt to get out of the fund. This was seen in DSP India Tiger Fund, SBI Magnum Contra Fund and SBI Magnum Taxgain 93.

Volatility impact

Small- and mid-cap funds have a higher beta and are first to fall in bear market

Top 5 high beta schemes	
Religare AGILE Fund (G)	1.1548
Religare AGILE Tax Fund (G)	1.0791
JM Core 11 Fund - Series I (G)	1.0485
ICICI Pru Banking & Financial Services (G)	1.0259
IDFC Equity Fund - A (G)	1.0181
Top 5 low beta schemes	
Edelweiss Absolute Return Equity Fund (G)	0.1622
Tata Growing Economies Infras-Plan A (G)	0.169
Reliance Small Cap Fund (G)	0.2304
Franklin Pharma Fund - (G)	0.3635
UTI-Pharma & Healthcare Fund (G)	0.3765

Fund managers play a crucial role in managing a fund. Exit of a seasoned fund manager from a fund house may affect the fund adversely. The fund house may not find a suitable replacement and this may lead to a drop in performance level. Such a phenomenon was seen in various funds managed by Sandeep Sabarwal, a fund manager with SBI. Funds like SBI Contra Fund, and SBI Magnum Tax Gain Fund 93 did very well during his tenure as fund manager between 1995 and 2005. As soon as he left the fund house in 2005, the performance of these funds took a hit. Also, Pricipal Emerging Bluechip Fund lost its top spot among the midcap category of funds in 2009 after the exit of fund manager Pankaj Tibrewal in January 2010.

It not always possible to catch hold of the best-performing fund. In fact, no fund can remain a best-performing fund for a long period of time. For instance, SBI Magnum Tax gain 93, Birla Tax Relief 96, and PNB Personal Tax Saver were among the best-performing funds in the equity-linked savings scheme (ELSS) category in 2005-2006. But since the downturn seen in the markets in 2008, these funds have struggled to get back to the top. In the diversified equity funds category, Sundaram Select Focus Kotak 30 and DWS Alpha Equity Fund were out of the rankings after witnessing the downturn. Thus, rather than focusing on rankings investors should opt for consistency and compare the performance with their respective benchmarks. If the fund is consistently beating the benchmark, then there is absolutely no need to get out of the fund.

Apart from comparison with the benchmark, match the performance of the scheme with the average returns of all the funds in the same category. This comparison is particularly useful for thematic and sector-oriented funds, where a comparable index or a benchmark is not available. Infrastructure funds are the perfect example where there is no comparable index. These funds are often benchmarked to the broader indices like S&P Nifty and BSE 100.

Though reviewing and churning of portfolio is an important process, it should be done only when required. Mutual funds and stocks behave differently. Stocks may give sharp moves on either side in a short time span as they are affected by news flows related to the company or the sectors in which they operate. A mutual fund, being a portfolio of stocks, may not show such sharp moves. Stocks may require a review even on a daily basis but a mutual fund portfolio may not require such frequent reviews. Also, as mutual funds are considered instruments for long-term investment, their performance should be compared over a longer time period.

Sectoral and thematic funds demand higher monitoring than diversified equity funds as fundamentals of sectors can change quickly due to various reasons like change in government policy, natural calamity or any major event. In 2008 and 2009, the pharmaceutical and FMCG sectors performed well as investors perceived these two to be defensive sectors. But as soon as the economy started to look up, other sectors such as banking, capital goods and IT outperformed.

Among diversified equity funds, small- and mid-cap funds should be reviewed and watched more closely than large-cap diversified equity funds. Small- and mid-cap funds have a higher beta and are the first to fall in unfavorable market condition. A beta of of one means the fund moves in tandem with the market, but a beta of more than one means it is more volatile than the market and may outperform the market when the markets is in an upswing and may underperform when the market is falling. A beta of less than one implies the fund's movements are smaller than that of the benchmark and may give returns below the market. Index funds and exchange traded (ETFs) i.e., funds traded on the stock excahge, too, need to be reviewed to keep a check that the tracking error is not very high and the fund management charges have not escalated above average.

Investors should also consider the tax implications of churning, which can invite short-term and long-term capital gain on sale of equity-oriented mutual funds. The rate of tax on long-term and short-term capital gain from stocks and equity mutual funds is the same. Short-term capital gain tax is 15%, while nil on long-term capital gain. But after the implementation of the Direct Taxes Code from the April 2012, the long-term capital gain tax on funds held for more than a year from the close of the financial year in which a scheme is bought will be nil if the securities transaction tax (STT) has been applied. For a scheme held for less than a year, the short-term capital gain will attract the personal marginal tax rate with 50% deduction.

The applicability of STT on stocks and units of mutual funds differ only if the units of equity mutual are not traded on the stock exchange. If the units are transacted on the stock exchange, they will attract STT. On redemption of units, the seller has to pay STT at the rate of 0.25%. The STT for stocks is 0.125% on both buy and sell transactions.

Mutual funds have become very cost-effective since the scrapping of entry load. Though exit loads still exist, it is small in percentage terms for open-ended equity funds. The exit load may vary from 0 to 1% of the redemption value and may also depends on the holding period. Lower the holding period, higher is the exit load and vice versa. Most funds have removed exit load if units are held for more than one year.

Though a mutual fund portfolio requires less amount of churning than a portfolio of stocks, investors should not ignore it. Having the right mix of funds at the right time will pep up the overall performance of the portfolio. At the same time, over-churning may lead to higher transaction cost and lower returns.

—Rahul Mantri

Keeping track

AUM of better performing funds tend to rise at a brisk pace

Top 5 schemes by AUM	
HDFC Top 200 Fund (G)	9357.9063
HDFC Equity Fund - (G)	8206.3908
SBI Magnum Tax Gain Scheme (G)	6089.9886
SBI Magnum SFU - Contra Fund (G)	3645.6497
ICICI Pru Infrastructure Fund - (G)	3604.8532
Five schemes with the lowest AUM	
Sahara Star Value Fund (G)	2.0805
Sahara Super 20 Fund (G)	1.6654
Taurus Nifty Index Fund (G)	1.3559
Escorts Leading Sectors Fund (G)	1.0206
Edelweiss ELSS Fund (G)	0.8

As on end October 2010.