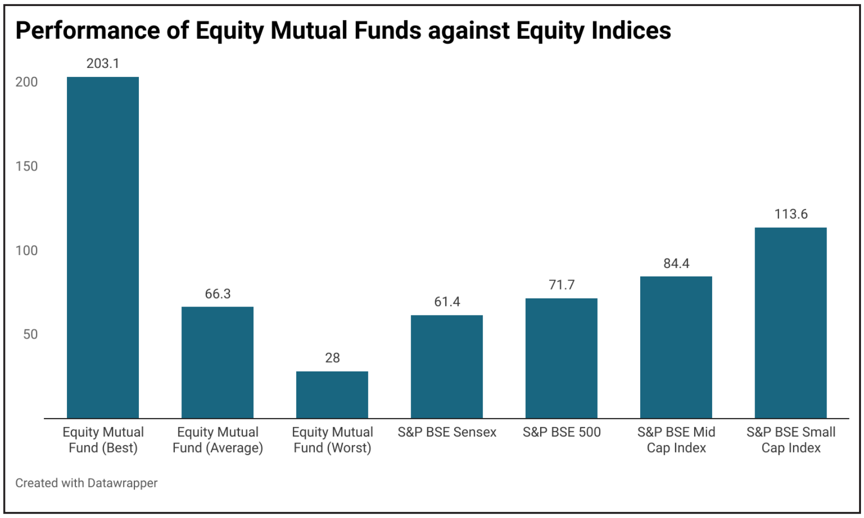
DALAL STREET INVESTMENT JOURNAL
DEMOCRATIZING WEALTH CREATION

How To Cherry-Pick Right Mutual Funds?

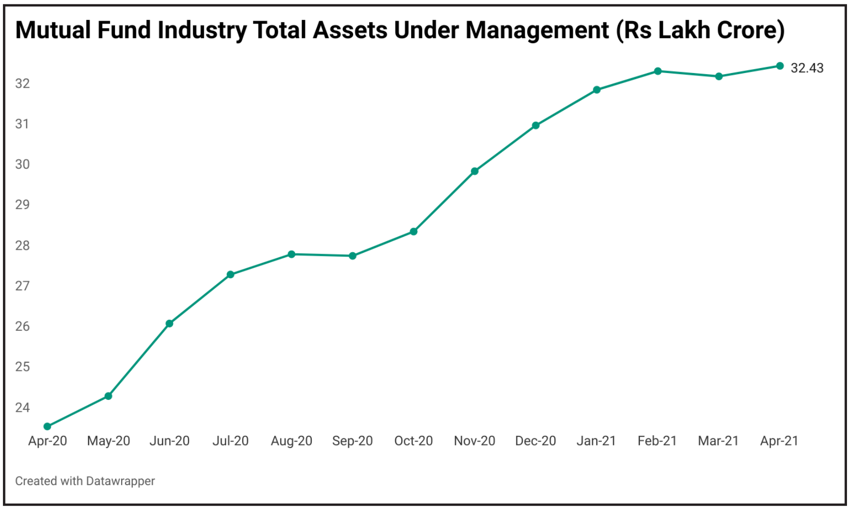
The global equity market saw a free-fall in the first quarter of CY20. The fall was so intense that the equity markets globally were down close to 40 per cent in a span of just two months.

However, amid relaxation from the COVID-19-induced lockdown, norms from June onwards gave wings to the equity markets and we saw the foundation of a new bull run. In fact, the returns generated in the next nine months were quite spectacular. Last time, similar returns were seen during the post-crash recovery during the 2008 global financial crisis. We, through our various writings in magazines as well as blogs, urged investors to remain invested during the period. Doing so would have helped them create substantial wealth in just a matter of few months. Even mutual funds were not behind.

DSIJ Pvt. Ltd., Office No. 211, Vascon Platinum Square, Next to Hyatt Regency, Viman Nagar, Pune- 411014
PH. 020-66663-800 / 801 ■ **www. DSIJ.in**



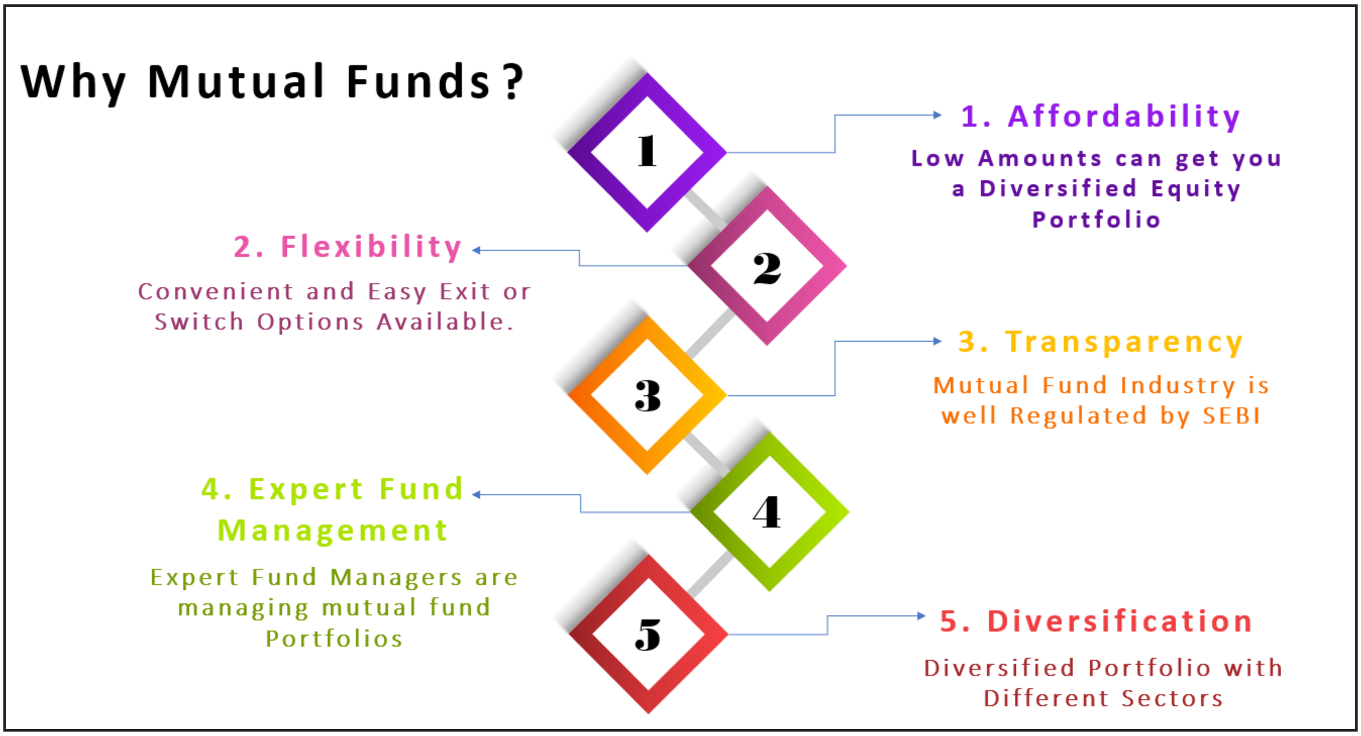
In the last one year, the lowest, as well as the highest returns recorded by any equity mutual fund, is 28 per cent and 203.14 per cent, respectively. On the other hand, the average returns of equity mutual funds in the last one year stand at 66.33 per cent. Now, if we compare this with that of S&P BSE Sensex, S&P BSE 500, S&P BSE Mid-Cap index and S&P BSE Small-Cap index in the last one-year, it registered returns of 61.4 per cent, 71.65 per cent, 84.41 per cent and 113.63 per cent, respectively.



The assets managed by the Indian mutual fund industry have increased from Rs 23.53 lakh crore in April 2020 to Rs 32.43 lakh crore in April 2021, i.e. around a 38 per cent rise in assets. This rise is despite retail investors ditching mutual funds to invest in stocks directly. It makes us ponder over a crucial question as to why do we need mutual funds at all?

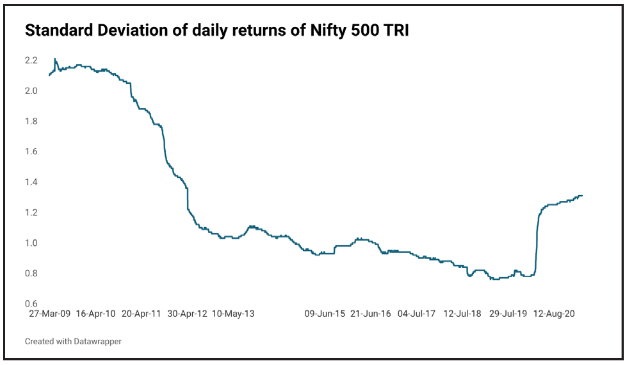
Why mutual funds?

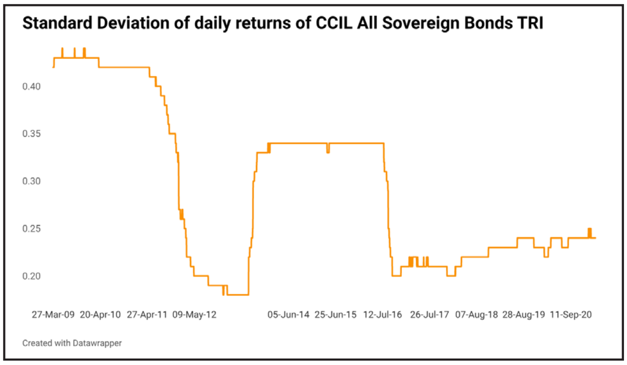
In recent times, many people ditched mutual funds and started investing directly. However, the mutual fund is the best-suited product available for most retail investors. Below, we have listed primary reasons as to why one should consider investing in mutual funds.



Return expectations

Usually, mutual fund investors have a different experience of investing in mutual funds. Some might not find value by investing in them or some may believe that it is the right way of investing. Such differences of opinion are due to return expectations. Hence, when you invest in mutual funds or rather in any investment product, it is always prudent to set the right return expectations. Setting the right return expectations usually helps in making the investment experience better. Moreover, it also helps you to select better mutual funds that suit your risk appetite. Now, you might ask what returns can be expected from mutual funds. Let us answer this question by taking the standard deviation of daily returns of Nifty 500 Total Returns Index (TRI) (representative of equity mutual funds) and CCIL All Sovereign Bonds TRI (representative of debt mutual funds).

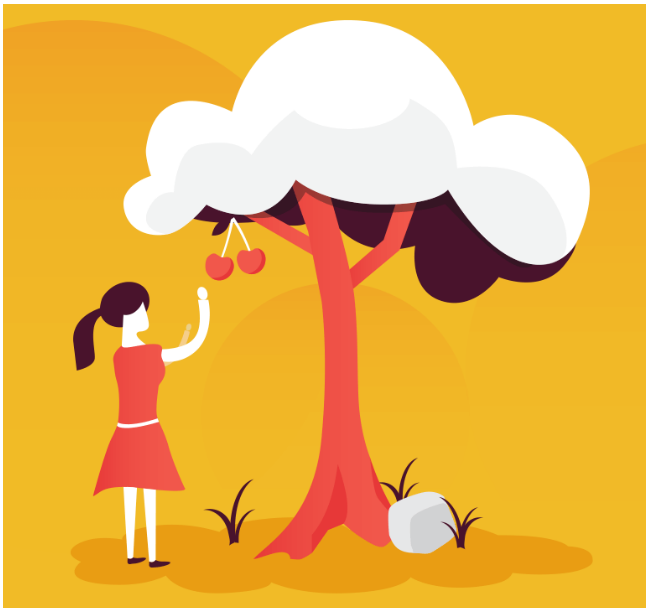




As we can see from the above two graphs, the standard deviation trend of daily returns of Nifty 500 TRI and CCIL All Sovereign Bonds TRI is declining. Lower standard deviations imply lower volatility and lower volatility, in turn, means lower returns. This means that the returns that you might have got 15 years back, you might not get now.

So, now, the next logical question is what returns expectation one should have from equity and debt mutual funds. In order to answer this, we calculated three-year rolling returns of Nifty 500 TRI and CCIL All Sovereign Bonds TRI. So, the average three-year rolling return of Nifty 500 TRI is 10.7 per cent and that of CCIL All Sovereign Bonds TRI is 8.3 per cent. Therefore, on a conservative basis, we can expect around 10 per cent to 11 per cent from equities and around 8 per cent from fixed income.

How To Cherry-Pick The Right Mutual Funds?



Mutual fund investing demands patience, efforts as well as risk appetite, especially if you are investing in equity dedicated mutual fund. Nonetheless, other benefits such as diversification, investment of your money in the right securities, the benefit of a qualified and experienced professional known as fund managers more than compensate your effort & risk. However, to choose from thousands of mutual fund schemes, one needs to take a few things into consideration.

Before investing in any fund, it is crucial that you first identify your financial goals. Identifying a goal would help you understand which asset class you need to invest in and how much. Besides, you should also decide your investment horizon. Here, we would be discussing the most crucial aspects that would help you pick the right mutual funds for you.

Investment objective & type of scheme

Among all the categories and schemes therein, you need to pick only those categories or schemes that have investment objective, which suits your financial goals and matches your risk appetite. If your financial goal is short-term and capital protection is your utmost priority, seeking debt funds with appropriate average maturity would be the right choice. However, your financial goal is to create wealth by investing for the long term, then funds having capital appreciation as their investment objective would be right for you.

Moreover, there are sub-categories to these broader categories picking the right sub-category is important. Therefore, we believe that when it comes to equity mutual funds, large-cap, mid-cap, small-cap, and Flexi-cap is enough to cover the entire spectrum of the equity dedicated mutual fund. In case of debt, liquid fund, low duration fund, short-duration fund, and gilt funds are more than enough for covering most of your requirements. Hybrid funds should be used by conservative investors to take equity exposure. In hybrid funds, aggressive hybrid, dynamic asset allocation or balanced advantage fund and multi-asset allocation fund is more than enough.

Assets under management

Once you have decided on the category and the sub-category of funds, the next pointer that you should check is assets under management or AUM. The idea is not to invest in a fund that has a very low AUM or a high AUM in its category. Funds with a median AUM of the category might be a good choice. Nonetheless, if you want a ballpark figure, in the case of equity, the funds should have a minimum AUM of Rs 50 crore. In the case of liquid funds, it should be more than Rs 20,000 crore. And in the case of other debt funds, it is more than Rs 500 crore. You might ask as to why in the case of liquid funds, the AUM requirement is higher. The reason behind the same is that many corporates invest in them and redemptions from them usually affect the liquidity of the fund. Therefore, investing in a liquid fund with a higher AUM would help in managing adequate liquidity.

Performance

Checking the performance of the fund often helps you to decide funds that you can bank on your money. Now, the question is how to evaluate the performance of mutual funds. We believe that checking three-year rolling returns, looking at its maximum drawdown as a risk measure along with the recent performance with the help of one-year rolling returns against category is a more suitable way of evaluating mutual fund returns. However, getting the data and processing it is quite tedious and time-consuming process. Therefore, for investors, it is a difficult task. So, you can select funds simply based on whether the fund is able to beat its benchmark in the short-term as well as in the long-term or not. If the fund is not able to beat its benchmark, then you should clearly avoid those funds. On the contrary, if the fund is able to beat its benchmark, then you can invest in that fund after checking other aspects such as portfolio, expense ratio, fund manager, etc.

Risk-reward Ratio

Performance alone does not matter; you also need to check the risk taken by the fund to generate such returns. While picking the right fund, make sure to also have a look at the fund's risk-reward ratios apart from its performance based on returns. There are two best ways to do that. You can look at the fund's Sharpe ratio and Sortino ratio. Both calculate the ratio that shows how much returns the fund generated for the amount of risk undertaken. The only difference between the Sharpe ratio and Sortino ratio is its risk metric that it takes into account to calculate the ratios. Sharpe ratio uses standard deviation while Sortino ratio uses downside deviation as their respective risk metrics. Moreover, you should select funds having Sharpe and Sortino ratio above one. However, if there are no funds in the category that have ratios greater than one, then you should consider the fund having better ratios than the category.

Fund manager

Being the captain of the fund, the fund manager plays a significant role in generating returns. Hence, before vesting your interest in a particular fund, be a smart investor and look at the track record of the fund manager. The fund's performance is often impacted by the fund manager's expertise and tenure.

Expense Ratio

There are various studies carried out around the world, which believe that the expense ratio is one of the best determinants of a fund's future performance. Such a study says that funds with lower expense ratios often perform better than those with higher expense ratios in the long term. Nevertheless, we believe that if a fund is charging a higher expense ratio, the fund should justify it. If they are able to beat benchmark indices and their category, then you can consider investing in them, irrespective of their expense ratio. However, the expense ratio can be a deal-breaker in a situation where you are confused between two or more such funds with more or less similar performance. In such a situation, you should pick funds with the lowest expense ratio.

DSIJ Pvt. Ltd., Office No. 211, Vascon Platinum Square, Next to Hyatt Regency, Viman Nagar, Pune- 411014
PH. 020-66663-800 / 801 ■ **www. DSIJ.in**