Are mutual fund schemes with concentrated portfolios a better choice?

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Mutual fund investors are warming up to the idea of investing in schemes with concentrated portfolios to rake in extra returns. Investors have become extremely wary of schemes after schemes holding the same prominent stocks in the name of diversification. Motilal Oswal Mutual Fund's impressive performance also caught the fancy of many investors. Cashing in on the positive sentiment, BNP Paribas recently launched a scheme with a concentrated portfolio. Are mutual fund schemes with concentrated portfolios better than schemes with diversified portfolios?

Vishal Dhawan, Founder & CEO - Plan Ahead Wealth Advisor, says the debate about diversification killing the returns has been there in the industry for a long time. He believes this is one reason why both investors and the industry players are looking at concentrated approach. "There has been a valid discussion about the size of the scheme leading to over diversification which may result in modest returns. After a point, all the large schemes will become index-hugging schemes with some variation. At this point a concentrated portfolio might be looked at as a better option to generate alpha," says Dhawan.

A scheme following the concentrated approach typically holds around 20-25 stocks in their portfolio, whereas a diversified portfolio usually has around 40-75 stocks. In a concentrated approach, the top 5 to 10 holdings constitute more than 50 per cent of the portfolio. Simply put, concentrated portfolios take higher exposure to the stocks that are the fund manager's best picks, with the objective of generating higher alpha.

"The most important aspect of the concentrated portfolio is the fund manager's skills. If your fund manager can take the best calls, you win and vice-versa," says Gautam Sinha Roy, Vice President - Fund Manager, Motilal Oswal AMC. In fact, that is the biggest trouble with a concentrated portfolio. If the fund manager gets it right, there would be extra returns. If he gets wrong, you will lose extra money.

That is why Gautam Sinha Roy says the concentrated portfolios are meant for savvy investors. "While we can always argue that it is for everyone, I think it is more relevant for investors who understand equities well and have faith in it. For retail investors, capital protection is the most important thing. For investors who cannot handle volatility, concentrated portfolios are not a great place, since the volatility is higher," says Roy.

On the other hand, a scheme following a diversified investment approach invests in around 50-75 stocks. Because of this, diversified equity funds typically have lower volatility. "Spreading out the money in too many stocks leads to lower returns because of the underperformance by some stocks in the portfolio. The good performers in the portfolio are pulled down by the bad performing stocks and over time, the degree of alpha gets diluted," says Vidya Bala, head of mutual fund research, Fundsindia.com.

As said before, investors have been cribbing about fund managers' tendency to invest in the same stocks and sectors to play it safe in the name of diversification. Experts believe that fund managers are trying to at least beat the index and stay on top. Obviously, the strategy result in modest returns.

"In a market like ours which doesn't have a broad-based rally, certain sectors tend to perform better at specific times. In this case, the focussed approach works better than the diversified one, says Bala. She also believes that the diversification works differently in different market capitalisations. For example, the largegcap category mostly hugs the benchmark. That is because a largecap fund cannot diverge too much from the index. However, the number of good stocks in the mid and smallcap segments are low. So, most schemes will have more or less the same set of stocks.

Finally, the investors need to be cautious while getting into a scheme with a concentrated portfolio. "One, you need to make it clear that a concentrated portfolio doesn't necessarily mean better performance. Two, the scheme can fall badly if the calls go wrong, since there is minimum diversification in the portfolio," says Dhawan.

That means, if you are willing to take the extra risk for better returns, you can invest in the schemes following a concentrated investment strategy. Before getting into the scheme, check the track record of the fund managerand the AMC. Only if you have faith in the fund manager, you should go ahead and invest. The expense ratio of these schemes tends to be higher than the diversified ones. Invest only if the expense justifies the returns.

How did they perform?

Scheme	Returns (%)		
	1 year	3 year	5 years
DSP BlackRock Focus 25 Fund	10.92	13.01	17.15
Axis Focused 25 Fund	22.58	16.66	17.53
Motilal Oswal MOSt Focused Multicap 35	24.19	24.31	NA
Motilal Oswal MOSt Focused Midcap 30	8.28	18.88	NA
Reliance Focused Large Cap Fund	12.92	10.82	15.3
UTI Focussed Equity Fund- Series I	15.34	9.96	NA

Data: Value Research

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