Business Standard

Five mistakes to avoid when investing in an ELSS fund

Here is a look at 5 key pitfalls investors need to avoid when selecting a tax-saver fund this season

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With the tax-saving season having begun, a lot of people are looking at investing in equity-linked saving schemes (ELSS), where they can get equity-like returns along with the benefit of tax saving. However, investors also make a number of mistakes when investing in these funds. Here are some of the common ones that they should avoid.

Beginning late in the year: Many people start investing in ELSS funds only towards the end of the financial year, when the time for showing proof of investment is upon them. This is a poor strategy. One, it could lead to cash flow related problems towards the end of the financial year. The second problem with investing at the end of the year is that it forces investors to invest a lump sum amount. This, in turn, creates the risk of market timing. If the equity markets are up, the investor ends up purchasing the fund's units at high valuations, which in turn affect his returns.

A new fund every year: Another commonly observed mistake is that investors put their money in a new ELSS fund every year. Over a 8-10 year period, they end up accumulating a large number of ELSS funds. This causes excessive diversification and results in a cumbersome portfolio that become hard to monitor.

Investing for three years: Of all the tax-saving products, ELSS funds offer the shortest lock-in of three years. In other products, it varies from 5-15 years. One mistake that people make is to pull out the money as soon as the three-year lock-in ends. This is a mistake. Since the underlying asset class here is equities, they should stay invested for a time horizon of at least five-seven years to garner good returns.

Not paying heed to nature of fund: Investors also sometimes don't pay attention to the market-cap orientation of the fund. Some of these funds are more large-cap oriented while others are more mid- and small-cap oriented. The former tend to be less volatile than the latter. If you invest just by looking at the returns of the funds in this category, without taking into account the nature of the underlying portfolio, you could end up with a fund whose risk profile is at variance with your risk appetite. "Often, an investor's first exposure to equity funds tends to be through ELSS funds. Such investors may have limited appetite for a more volatile, mid- and small-cap oriented fund. For them it is all the more important to stick to a large-cap oriented fund," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Betting on the current best performers: The funds that are topping the charts currently (in terms of trailing returns over the past one or three years) may not be the best choice for you. Instead, investors should focus on funds that have a track record of consistency. To select a consistent fund, compare the fund's performance with that of its category average year-wise for the past five or seven years. Another alternative is to compare rolling returns. This is a good measure for capturing consistency.

Five tips for ELSS investors

Start your SIP in an ELSS fund in April instead of waiting for the last quarter

Choose a good fund and stick to it year after year instead of betting on a new fund every year

Equities need five-seven years to show good returns, so don't pull your money out as soon as the lock-in ends after three years

If you want a less-volatile fund, go with one that is large-cap oriented

Choose a consistent performer instead of the current top performer