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Do you need dynamic funds in your portfolio?

These schemes use different methods to decide their equity-debt asset allocations. But performance comparison is difficult because of their short track records and different strategies used

Kayezad E. Adajania

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Whether markets go up or down, equity funds are mandated to hold most of their portfolio in equities. But there is one breed of funds that can hold less equity in rising markets and also a lot of cash and fixed income. These are called dynamic funds, or asset allocation funds. With equity market at 28,000 levels and its one-year price-to-equity ratio at 17 .6 (as on 3 October), Franklin India Dynamic PE Ratio Fund of Funds—the oldest dynamic fund—had 40% in equities at the end of August 2016, versus 66% in September 2013. But HDFC Dynamic PE Ratio Fund of Funds had 68.81% in equities. Schemes like ICICI Prudential Balanced Advantage Fund and Birla Sun Life Dynamic Asset Allocation Fund had 38.5% and 63.79% in direct equities, but if you add their arbitrage and derivatives exposure, they had about 65% and 67% of their total portfolios in equities.

Different strokes

If equity markets are rising higher (on 8 September, the S&P BSE Sensex closed at 29,045; the year's highest), why some of these dynamic funds' equity exposure is in 60s and 70s and others invested just 20-30% in equities? That's because different funds have different strategies.

The Franklin India Dynamic scheme decides its equity-debt allocation based on the one-year P-E ratio (based on past earnings) of NSE Nifty 50 index. The HDFC Dynamic PE scheme decides its equity-debt allocation based on one-year forward P-E of Nifty 50. Both schemes are fund of funds, i.e., they invest in other schemes. This also means that schemes can get classified as debt schemes since income tax rules say that fund of funds are classified as 'non-equity' schemes and their taxation status is the same as that of a debt funds.

To overcome this challenge, some funds invest directly in equities. But to qualify as an equity fund on the taxation front, their average equity exposure in the past 12 months has to be at least 65%. So, schemes like ICICI Prudential Balanced Advantage Fund, IDFC Dynamic Fund and L&T Dynamic Equity Fund invest in a mix of equities, arbitrage opportunities and debt securities. Since arbitrage exposure is considered equity, these funds end up having a cumulative equity exposure of at least 65%.

"For those investors who want to enter the equity markets for the first time, we have to give an alternative that enables them to buy equities when they are low and sell when equity markets are at a high. The P-E levels indicate whether the market is cheap or expensive," said Soumendra Nath Lahiri, chief investment officer, L&T Investment Management Ltd.

Have they delivered?

There's no clear answer to that yet. Most dynamic and asset allocation funds don't have a long-term track record. The oldest of the lot was launched in October 2003. Few others had different avatars earlier. L&T Dynamic Equity Fund was earlier a children's education focused hybrid scheme. Kotak Asset Allocator Fund used to invest only in equity funds and in other fund houses' equity schemes. In September 2014, it changed strategy to also include debt funds, and only in-house schemes.

The past 1 year is a safe period to see how most of these schemes have performed, because this track record is available for most such schemes.

But can you really compare one such scheme to another? All such funds have different models to determine the equity-debt split. For instance, HDFC Dynamic PE Ratio scheme looks at forward earnings. But these are just estimates, even if they are, as HDFC Asset Management Co. Ltd says in its offer document, "Bloomberg Consensus estimate". Some funds look at past earnings.

There are different perspectives to which is better method. Nikhil Kothari, chief financial planner, Etica Wealth Management Ltd, a Mumbai-based financial planning firm, said, "If the fund manager expects a mass improvement in company earnings and her prediction comes true, the forward earnings model will immensely benefit as that scenario would show a low P-E in present time, and this scheme's equity exposure would be high."

"That may be true but 'forward' is subjective. What if your call is wrong? Backward looking P-E ratio is based on facts and is more transparent," said P.V.K Mohan, head–equity, Principal Mutual Fund.

That's one reason why the asset allocation of these funds, and their performance, can differ vastly. Plus, there are different benchmark indices. However, financial planners say most of these funds pitch themselves as products that can beat the equity markets in the long run, but with lesser volatility. So, a common benchmark could be a broad market index like the Sensex or the Nifty.

We looked at 1-year rolling returns to check consistency. Then, we compared returns to that of the Sensex over the same period. Most fund of funds outperformed the Sensex. But this is also because the ones that invest directly in equities do not have a long track record. These are early days. Hardly any of these schemes has seen more than one market cycle to test their models.

What should you do?

Vishal Dhawan, founder and chief executive officer of Mumbai-based Plan Ahead Wealth Advisors, said such funds are good for do-it-yourself investors. "It works well for them as it does the rebalancing of equity debt assets, automatically. For these investors, the biggest challenge is that they tend to be overweight in one asset class at a point in time and they do nothing about it."

But understanding these funds can be difficult. "These funds may be sophisticated but retail investors find it difficult to comprehend their formula. When these funds don't do well, it's difficult to explain to investors the formula that led to the equity-debt split which may have contributed to underperformance. Perhaps investors understand pure equity and pure debt better," said Ravi Kumar T.V., founder, Gaining Ground Investment Services, a Bengaluru-based mutual fund distribution firm.

We agree. The simpler your portfolio, the better it is for you.