Decoding mutual fund investments

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ROUTE MAP

- Build your mutual fund portfolio in two portions — a core and satellite strategy.
- Restrict the overall number of funds in the portfolio.
- A total number of five funds across the core and satellite strategy should be sufficient.
- Buy products with long track records.
- Avoid timing the markets.
- Avoid frequent changes in the portfolio as they increase cost and taxes.

THE MUTUAL fund industry is witnessing a strange paradox. Despite low costs, the industry is not able to arrest the declining volumes. The same applies to the scenario in Ulips, which failed to woo investors despite clarity on Ulip regulations.

The classical economic theory would suggest that volumes actually increase with lower prices. There are good examples of this in India — be it mobile phones or more recently LCD TVs. Clearly, that has not been the case with financial products like mutual funds.

The longer-term growth story of India continues to be recognised by domestic and international investors and a large number of fund managers have built long-term track records of outperformance against benchmarks like the Sensex. But these facts lead to the question: "Why are investors not taking advantage of lower costs?. And if they wish to, how can they go about it ?"

If you want to utilise the advantage of low costs. You have to build your mutual fund portfolio in two portions — a core and satellite strategy. The core strategy should consist of a combination of index and diversified funds that invest in large firms. This should make up at least 75 per cent of the overall portfolio.

The satellite part of the portfolio should consist of products where you would actively seek outperformance over benchmarks like a mid cap fund or even a thematic product like an infrastructure offering.

This part of the portfolio could make up the balance 20-25 per cent and will need active monitoring to ensure that it delivers the outperformance that is expected from this part of the portfolio.

Restrict the overall number of funds in the portfolio. Keep in mind that mutual fund portfolios consist of a large number of stocks, so further diversification is not necessary. A total number of five funds across the core and satellite strategy should be sufficient.

Since a large number of products have more than a decade-long track records, it is critical to evaluate the track records of the products you choose, rather than rushing into a new fund offering. Remember that you need to evaluate risk adjusted returns, and not returns on a standalone basis, so if you are unable to choose the appropriate products yourself, take the help of an expert with proven research capabilities.

Be ready to pay for these services just like you pay for other services. There is no empirical evidence of significant outperformance of portfolios by buying at the lowest point and selling at the highest point, so use a regular investment strategy.

Avoid frequent changes in the portfolio as they increase cost and taxes, thereby lowering overall returns. Almost everyone understands the merits of long-term investing but the definition of long-term varies. So you have to correctly define long-term.

Our view is that you need to define long-term as five years at the bare minimum and ideally 10 years and above. Over the last 10 years, the Sensex has delivered a return in excess of 14 per cent per annum.

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