# Falling performance of large-cap funds

## Shift 20-25 per cent of your equity fund exposure to passive funds

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If you review the performance of large-cap funds over the past one year, actively-managed funds in this category have underperformed passive funds. These funds have given a category average return of -2.98 per cent. Among passive funds, Sensex-based exchange traded funds (ETFs) have given a return of 7.46 per cent, while Nifty-based ETFs have given 4.62 per cent (see table: *Declining fortunes*). A similar trend of underperformance by large-cap active funds is visible over the three-year horizon.

Outperforming vis-a-vis the total return index is also proving difficult. "Earlier, their performance against a price return index – Sensex or Nifty. Now they have to showcase it against a total return index, which also includes dividend," says Vishal Jain, head ETF, Reliance Nippon Life Asset Management.

Jain also points out that many large-cap funds invested in the mid- and small-cap stocks which helped them get better returns. With the re-categorisation of mutual funds and the markets regulator Securities and Exchange Board of India defining large-caps, mid-caps and small-caps, the leeway to include mid-cap and small-cap stocks has reduced. Large-cap funds can now only keep up to 20 per cent of their portfolio in mid- and small-cap stocks. A more tightly defined mandate will reduce the flexibility of fund managers and make it harder for them to outperform.

The fund house is already witnessing long-term investors shifting to ETFs. Reliance ETF Junior BeES, which had a corpus of ₹1.5 billion a year back now has an AUM over ₹6 billion.

IMAGE: iSTOCK

### DECLINING FORTUNES

| Benchmark | Category average return (%) 1-year | 3-year | 5-year |
|---|---|---|---|
| Large-cap active funds | -2.98 | 7.84 | 14.24 |
| Sensex ETFs | 7.46 | 10.17 | 12.42 |
| Nifty ETFs | 4.62 | 10.14 | 12.71 |
| MNC funds | 1.42 | 6.32 | 20.72 |

Source: Ace Mutual Fund

### TOTAL RETURN CHALLENGE FOR FUNDS

| | Absolute | | CAGR | |
|---|---|---|---|---|
| Benchmark | YTD | 1 Year | 3 Years | 5 Years |
| S&P BSE SENSEX | 3.25 | 7.75 | 8.91 | 11.33 |
| S&P BSE Mid-Cap | -18.43 | -9.42 | 9.57 | 20.03 |
| S&P BSE Small-Cap | -24.11 | -14.03 | 8.27 | 20.69 |
| S&P BSE SENSEX - TRI | 4.28 | 8.98 | 10.32 | 12.86 |
| S&P BSE Mid-Cap - TRI | -17.70 | -8.56 | 10.82 | 21.49 |
| S&P BSE Small-Cap - TRI | -23.58 | -13.39 | 9.13 | 21.78 |

All figures in per cent; Source: Ace Mutual Fund; As on - 17-Oct-2018

**Narrow large-cap rally, steep mid-cap correction:** A variety of factors have led to the underperformance by actively-managed large-cap funds. In recent months, returns in the large-cap space had become very concentrated. Only a few heavyweights stocks funds performed while the larger part of the market was in correction mode. This narrowness of performance added to their underperformance.

While large-cap ETFs have exposure only to large-cap stocks, their actively-managed counterparts have mid- and small-cap exposure as well. Mid- and small-cap stocks, which had been outperforming for the past four years, have corrected sharply (the S&P BSE Midcap Index is down 18.43 per cent year-to-date while the S&P BSE Smallcap Index is down 24 per cent). "Exposure to mid- and small-cap funds, which in earlier years was responsible for outperformance, has been responsible for the underperformance of large-cap funds owing to the sharp correction in these stocks over the past 6-10 months," says Nikhil Banerjee, co-founder, Mintwalk.

The higher expense ratios of actively managed funds have also contributed. Actively managed large-cap (regular) funds have an average expense ratio of 2.50 per cent. The average expense ratio of Nifty and Sensex based ETFs is barely 10 basis.

Fund sizes have also contributed. The biggest large-cap fund today has assets under management (AUM) of ₹208.94 billion. Five funds have AUMs above ₹100 billion (the average size in this category is ₹33.72 billion). "A larger fund size makes it more difficult for fund managers to change portfolios quickly if a particular strategy has not worked," says Banerjee.

**A longer-term trend:** Outperformance by actively-managed large-cap funds has been declining for some time now. With the Indian stock markets, especially its large-cap segment, becoming better researched, it has become harder for active fund managers to outperform. A study done by Edelweiss Mutual Fund some time back had found that outperformance by large-cap funds has been shrinking for quite a few years now.

One way fund houses could check this trend is by reducing the costs of actively managed funds significantly.

Take exposure to passive funds: Financial advisors suggest that investors should now take exposure to a combination of active and passive funds in their portfolios. "Some fund managers will continue to outperform. Investors should have 75-80 per cent of their portfolios in actively managed funds and take 20-25 per cent exposure in passive funds," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors. This exposure to passive funds should be primarily in the large-cap space - through Sensex and Nifty-based ETFs.

Some active fund managers will continue to outperform. Fund manager selection will, henceforth, become crucial. "Go with a fund manager who has seen a few market cycles. He should have been handling that fund for at least four-five years and the fund management team around him should also be stable," says Banerjee. He adds that in large-cap funds portfolios remain relatively stable, so one should opt for a fund manager who has been able to outperform with relatively low portfolio churn.

Investors should also give preference to funds having a lower expense ratio, and preferably go for direct plans, which have lower costs.

ETFs based on smart-beta indices have also been launched. They do not have much of a track record at present. Investors should, however, keep an eye on their performance and consider investing in them in the near future.

**Continue with active mid-and small cap funds:** In this category, evidence shows that active fund management still works better. Here fund managers have an opportunity to go for previously unrecognised stocks, or come across large discrepancies between a stock's price and its intrinsic value. The numbers put out by companies in these spaces are not wholly reliable, so there is a need for analysts to actively vet them. The number of passive fund options available today in this space is very limited.