What should be your mutual fund strategy in 2022

By Vishal Dhawan, ET contributors. Last Updated: Dec 24, 2021, 09:27 AM IST

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Prashant and Rashmi (names changed), were reviewing the progress on their financial goals annually with us, just as they normally did and exactly like most of our other client families do. The progress on most of their financial goals looked very good in 2021, making them think about a retirement earlier than what they had originally planned for. A large reason for this meaningful progress with their financial goals was the excellent performance of their equity mutual fund portfolio. This was was largely due to the fact that 2021 was a year where equities did extremely well, both domestically in India as well as in most parts of the globe.

The performance of their fixed income and gold mutual funds in contrast were relatively subdued and thus they wanted us to reduce their debt mutual fund exposure and gold ETF exposure, and allocate more monies to equities especially if there were any corrections along the way. A buy on dips strategy for investing in lumpsum into equity mutual funds, as well as a regular SIP strategy had worked very well in 2021 for equity mutual fund investors.

In addition, the larger the exposure was to Indian equities, the better the portfolio had done as Indian equity markets had outperformed most other markets in the globe. With fixed income yields having come down significantly due to excessive liquidity, Prashant and Rashmi also wanted to know if there was a way to increase their returns from the debt mutual funds by looking for higher yielding mutual funds, as they had read that there were fixed income funds that were investing in bonds that gave a higher rate of interest as well.

Whilst 2021 was a good year for Prashant and Rashmi looking at the past, our advice to them for 2022 as they look forward includes:

• ***Avoid falling into a recency bias trap*** – Considering that Indian equity mutual funds have done so well in 2021, there may be a tendency to extrapolate the returns of 2021 to 2022 and beyond as well. It is very unlikely that returns from equity mutual funds can be repeated consistently at this rate going forward, and it is therefore crucial to set expectations of significantly lower returns going forward.

• ***Allocate monies globally*** – Whilst India has been one of the best performing markets in 2021, there is enough empirical evidence over the years to show that winners rotate and the best performing geographies change. Therefore having an internationally diversified portfolio is recommended, with exposure to a combination of developed market funds and emerging market funds, besides allocations to Indian equities.

• ***Stay away from chasing high yield*s** – With yields being low from debt funds, it is very tempting to buy into debt funds with higher yields. However, one should not forget the lessons of 2020 wherein funds with low rated bonds and higher yields ran into significant challenges, and monies were stuck as they chased higher yields. Allocate only a small portion of money to higher yield debt funds, and be aware of the accompanying risks.

• ***Do not exit gold due to its recent underperformance*** – Gold has traditionally had a negative correlation to equities and it is therefore very common to see gold underperform in periods where equities do very well. Allocating monies to gold funds continues to be a good idea for protection against equities as well as a depreciation in the Indian rupee.

• ***Buy on dips may not always be a winning strategy*** – It has been seen historically that when equities correct sharply, they could take a considerable amount of time to get back to their principal value and then start generating returns. These periods can sometimes stretch into years, and thus it is crucial that equity mutual fund holdings therefore have an investment horizon of at least seven to ten years.

• ***Rebalance your portfolio*** – Due to the outperformance of equities, it may be a good idea to rebalance portfolios by reducing equity funds and adding to debt funds and gold to partially exit assets that are highly priced, and move monies to assets that are more reasonably priced

• ***Enhance exposure to passive funds and ETFs*** – With returns expected to become lower going forward, index funds and smart beta funds could be looked at for incremental allocations, so that the costs of the portfolio are reduced.

• ***Avoid chasing the best themes of 202*****1** – The best performing themes of 2021 like technology are now significantly more expensive than they have been in the past and therefore chasing returns there may not be prudent. Avoid chasing thematic funds, especially those that have done very well in the recent past.

You could also consider following the advice for Prashant and Rashmi, but do not forget to customise it to your own financial goals.

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