How to evaluate the Fund Manager of Mutual Fund

Mutual funds are increasingly finding greater acceptance among investors, when it comes to planning their finances. However, given the numerous schemes in each category, and many more being launched every month, how does an investor determine where to invest? To start with, we recommend that you take a close look at the fund management team, in other words, the brains behind the mutual fund.

The fund manager, also known, as the "Portfolio Manager" is an individual (although increasingly, he is being replaced by a team of two to three fund managers) who decides where, and in what allocation, money is to be invested. Given the importance of the fund manager/fund management team, it is pertinent that you, the investor, evaluate him very carefully.

Here are some parameters on which you should evaluate the fund manager:

1. Adherence to mandate

Every mutual fund scheme has an investment objective, which the fund manager must adhere to. If the fund manager is not faithful to the mandate, then you may find yourself invested in a scheme whose objectives no longer match yours. And then of course, if you were to take corrective measures, there will be implications in terms of taxation and loads.

There have been instances when funds change their mandates depending on what's "hot" in the stock market. Such funds again must be avoided as their focus is on asset accumulation and not money management. A fund manager who adheres to the mandate under all conditions regardless of market conditions should be preferred over one who does not.

2. Investment style

It is important for an investor to understand the investment style followed by the fund house. One way to classify investment styles is individualistic style and team-driven style. The basic difference between the two is that in the former, you have a 'star' fund manager who plays an important (at times, even indispensable) role in taking investment decisions. In the other style, there is a team that takes the investment decision based on certain processes and systems. The

team has a fund manager who participates in the investment process, but he is not a star; instead, he takes the final call based on the team's consensus. Needless to say the second approach is a lot better; one key reason being there is no over-dependence on one individual.

Investors must be cautious while investing in a fund that pursues the individualistic brand of fund management. This is particularly so, since switching between fund houses is a common practice within the fund manager community. Testimony to this fact is that apart from a few names, we can't think of many fund managers who have been associated with a fund house for more than even 5 years. When a star fund manager quits the fund house, the existing funds could witness a dip in performance. Also investors are hassled into tracking his whereabouts and then investing/ redeeming their monies based on his latest employment.

One thing that is critical while deciding on which mutual fund to opt for is to ascertain whether the fund house has a process-driven approach to identifying the right investment opportunity. A process-driven approach brings in discipline, which in the long-term is a key factor in determining performance.

3. Evaluating performance

Higher returns or a rapidly appreciating NAV (net asset value) do not necessarily mean that the fund manager is doing the right thing. There is a lot more to performance than just the headline NAV return number. Among the 'numbers' one should focus on.

One, the most basic - a comparison of the fund's performance over various time periods vis-a-vis both the benchmark index and its peers. The comparative performance, both absolute and risk-adjusted, will give you an insight into the fund manager's ability to outperform the peers and the benchmark over different periods of time. A well-managed fund should be a consistent outperformer.

Two, the performance of the fund during downturns in the market should be evaluated carefully. A fund managed by a smart fund management team should ideally fall a lot lower than the market due to the prudent investment calls. Remember, it's only in lackluster/bear markets, that the stock picking ability of the fund management team really comes into play (in bull markets almost anyone can deliver a return).

Above we have listed just three points for you to keep in mind when selecting the right fund manager/team while investing your money. Once you select the right fund management team, you have made a start, but there is a lot more homework still to be done in terms of selecting the right mutual fund. An easier alternative is to engage the services of an honest and competent financial planner.

How to select a diversified equity fund

When it comes to making investments in mutual funds, it all boils down to which fund to invest in. There is no dearth of choices, but then not all the options available merit consideration. There are 30 asset management companies (AMC) currently in the mutual fund industry, and many more lining up for launches. The variety of schemes offered by these AMCs is enormous. So it can be a challenge for the investor when it comes down to identifying a handful of mutual fund schemes from this rather large universe. The good news for the investor is that based on performance, most of these schemes fall short of making the grade. Thus the real challenge lies in finding those few schemes that do make the grade.

Often when it comes to evaluating their investment decisions, investors appear confused. The simplest of decisions proves elusive to them. This confusion is further enhanced by misrepresentation made by 'commission-hungry' mutual fund agents.

With so many forces working against them, it's essential for investors to have a set of objective parameters based on which the performance of mutual fund schemes can be evaluated. These parameters should serve as benchmarks for investors while selecting funds for their portfolios. We present a 4-step strategy for selecting the right diversified equity fund.

1. Compare returns across funds within the same category

One of the most basic forms of benchmarking involves comparing funds within a category. For instance, if you are evaluating Franklin India Bluechip Fund for investment, you should compare its returns with other predominantly large cap diversified equity funds. Comparing it with mid cap funds for example, will deliver erroneous results, because the risk-reward relationship between mid cap and large cap funds are not comparable.

As equities are best equipped to deliver returns over longer time frames (3-5 years), investments in diversified equity funds should be made with a long-term perspective. Hence, while comparing returns, investors must consider longer time frames (of 3-5 years) before taking a conclusive decision about investing in a fund. Comparing a fund over a longer time frame will also give investors a good idea about how the fund has fared over a stock market cycle (boom and bust).

2. Compare returns against those of the benchmark index
Regulations demand that every fund mentions a benchmark index in the Offer Document. The benchmark index serves the dual purpose of being a guidepost for both the fund manager and the investing community. All eyes must be on the benchmark index and how the fund has fared against it. Again with an equity fund, investors should consider the performance of the fund over the longer time frame, while comparing it to its benchmark index. In the Indian context, most equity funds outperform their benchmark indices over the long-term (3-5 years). However, during market turbulence, like the one witnessed over May-June this year, investors will find many equity funds trailing their benchmark indices. This is something we have observed on more than one occasion. The funds that can outperform their benchmark indices during stock market volatility must be marked closely.

3. Compare against the fund's own performance
Besides comparing a fund with its peers and benchmark index, investors should evaluate its historical performance. Not all funds show stability in performance over the years. Many of them slip up; only a few manage to sustain the good work they have done year after year, market cycle after market cycle. By evaluating a fund against its own historical performance, you ensure that you get the most consistent performers in your mutual fund portfolio. The inconsistent performers (the one rally wonders) are available a dime a dozen and must be filtered effectively.

4. Risk-related parameters
While NAV returns are important, one area, which should never be ignored by investors is the risk taken on by the fund. Mutual funds being market-linked, are prime candidates for stock market related risks. The two aspects that investors should take into account are volatility of the fund as indicated by the Standard Deviation (SD) and risk-adjusted returns as calculated by the Sharpe Ratio (SR).

While SD shows the degree of risk taken on by the fund, SR shows the return generated by the fund per unit of risk taken. The SD (volatility) of a fund should be lower than its peers; on the other hand, the SR should be higher. The best fund is the one with the lowest SD and the highest SR within its peer group. Again, it is advisable for investors to evaluate the SD and SR of the fund on a historical basis so as to identify the most consistent performers.

Index funds: Short-term wonders!

In terms of fund management, mutual funds can be broadly classified into two categories: actively managed funds and passively managed - better known as index funds. In an actively managed fund, the fund manager uses his expertise and skills to select stocks across sectors and market segments. The sole intention of actively managed funds is to identify the best investment

opportunities and exploit it in order to generate superior returns, and in the process outperform the benchmark index.

On the contrary, index funds are aligned to a particular benchmark index like the Nifty or Sensex. They attempt to mirror the performance of the designated benchmark index, by investing only in the stocks of the index with the corresponding allocations.

In developed economies like the United States for instance, index funds are very popular among mutual fund investors and are preferred over actively managed funds. This is because of the clear advantages they offer to investors, like no loads and lower expenses among others. Moreover, in the United States, stock markets are more efficient, so investment opportunities are at a premium. They are relatively difficult to identify, because widely disseminated research makes just about everyone aware of these opportunities, so this blunts the first mover advantage. As a result, a number of actively managed funds in developed economies fail to outperform the broader stock market indices thereby pushing the cause of index funds.

Investing in index funds is relatively less cumbersome. Here, the two most important points which investors have to look out for are the expense ratio and the tracking error (i.e., the difference between the returns clocked by the benchmark index and index funds). Thus, unlike actively managed funds, index fund investors can forgo other aspects of investing such as fund house's investment philosophy and the kind of funds to choose - a large cap/mid cap/small cap fund.

On the other hand, investors investing in actively managed funds have to assess all the above-mentioned criteria and more before investing. These funds have to capitalise on the opportunities in the market to generate superior returns. Thus, in the process they employ more resources (more analysts/fund managers) and in turn charge higher expenses than index funds.

In the Indian context, the mutual funds segment is dominated by actively managed funds. Index funds occupy a much smaller share of the market. This is because Indian stock markets, being in a developing phase, still offer enough investment opportunities that if identified earlier on can outperform the benchmark index over the long-term (3-5 years). So well-managed actively managed funds have done a reasonable job of going one up over the index over the long-term.

We did a brief study wherein we faced-off the average category returns of index funds (passively managed) vis-a-vis those of diversified equity funds (actively managed). In a way, the results are on predictable lines.

Active Funds: Long-term bets

Categories	Average category returns		
	1-Yr (%)	3-Yr (%)	5-Yr (%)
Index funds	55.5	35.0	32.7
Diversified equity funds	40.4	42.6	45.3

(Returns as on October 16, 2006)

On comparing the category average returns of active funds and passive funds over varying time frames, one can conclude that it's something of a mixed bag, with each category performing well only over a certain time frame.

For instance, over 1-Yr, index funds (55.5%) are ahead of diversified equity funds (40.4%). However, extend this time frame to 3-Yr and even 5-Yr, and the scenario changes completely. Gone is the sheer domination of index funds over active funds. Over 3-Yr, diversified equity funds (42.6%) have comprehensively outperformed index funds (35.0%) by 7.6%, and this gap further widens to 12.6 % over 5-Yr.

In a nutshell, even in the Indian context, index funds offer advantages like lower expenses (although they aren't quite as low as they should be compared to US Index Funds) and lower volatility in performance as compared to actively managed funds. They can also outperform actively managed funds although usually only over shorter time frames (less than 3 years). But over longer time frames of 3-5 years (which is ideal for evaluating equity-oriented funds), actively managed funds more than hold their own against index funds.

Hence, for risk-taking investors, actively managed funds should occupy a larger share of the portfolio. Index funds can also occupy a smaller share, mainly from a diversification perspective.

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Fixed Maturity Plans Vs Capital Protection Schemes

Recently, a new category named Capital Protection Oriented Schemes (CPOSs) made its debut in the mutual fund industry. As the name suggests, the mainstay of such schemes is to provide capital protection. Structurally they are similar to another existing mutual fund category called Fixed Maturity Plans (FMPs), which has been around for a while. For investors, the presence of these categories which are structurally similar, yet distinct in terms of positioning can be confusing. We decided to face-off the two categories and find out how similar or dissimilar they are.

To start with, let us first look at the two categories independently and understand what they offer to investors.

FMPs are close-ended debt funds (investments can be made only during the new fund offer period) with a fixed maturity horizon. They can also invest a smaller portion of their corpus in equities. FMPs target a given yield (return), lock-in the same at the time of investment and stay invested till maturity. In turn, investors who stay invested in the fund till its maturity are virtually assured of clocking the designated returns. It should be understood, that being a market-linked investment avenue, the returns aren't assured or fixed. Hence, deviations in the designated returns

on account of market fluctuations cannot be ruled out.

Conversely, CPOSs are close-ended debt funds, oriented towards the protection of capital invested. Again, the capital protection is not guaranteed. The portfolio is constructed in a manner to provide the investor with at least the amount invested on maturity.

As mentioned earlier, both FMPs as well as CPOSs are structurally similar to each other. Both the schemes attempt to combine the stability of debt along with the power of equities. Normally, these funds invest a majority of the corpus (say atleast 80%) in debt instruments and the balance (around 20%) in equities. The portfolio is so designed, that the amount of money invested in the debt component is equivalent to the initial investment on maturity. For example, out of Rs 100 invested, the fund invests Rs 80 in debt instruments, which will amount to Rs 100 on maturity. Thus, the debt portfolio attempts to preserve the initial investments made by investors, while the equity portfolio (Rs 20 in this case) is utilised to generate capital appreciation.

FMPs and CPOSs have certain dissimilarities as well:

- CPOSs are oriented towards capital protection, hence the defining feature of schemes from the segment is providing safety of capital. Generating capital appreciation is relegated to second position.

  Conversely, FMPs are return-oriented investment avenues and not inclined towards protection of invested amount. The primary aim of such funds is to generate returns.

- As per SEBI (Securities and Exchange Board of India) guidelines, it is mandatory for all the AMCs (Asset Management Companies) to get the proposed portfolios of their CPOSs rated by a SEBI registered credit rating agency. Also, the rating has to be reviewed on a quarterly basis and AMCs must ensure that the debt component of the portfolio has the highest investment grade rating (AAA or P1+).

  FMPs tend to primarily invest in debt instruments with a high credit rating as well, but they have a free hand in terms of the instruments they can invest in. Similarly, it is not mandatory to get the portfolio rated by any credit rating agency.

- CPOSs are close-ended in nature and don't offer any option to investors for premature withdrawals. Hence investors are advised to park only that portion of their investible surplus, which can be put aside for a longer time frame.

  Investors in FMPs have the option of prematurely exiting their investments; however, the

same would attract an exit load as specified by the fund house

Investors would do well to understand that both CPOSs and FMPs cater to the needs of different types of investors. For an investor, who accords greater importance to capital preservation over capital appreciation, CPOSs is the place to be. On the other hand, investors who are looking at clocking a "somewhat" assured income, FMPs should be the chosen investment avenue. It is essential for investors to be aware of the nuances of both the categories, so that they can make more informed investment decisions.