Image courtesy: Mirae Asset

Mutual Funds

'Alpha' Way to Find the Right Fund

As an investor it may not be enough for you to know Mutual funds *sahi hai*! Rather, it will be more important to know which mutual funds are right.

India's mutual fund landscape has seen explosive growth thanks to aggressive advertisement, product pushing through banking channels and stock market performance. We see cricket celebrities endorsing the slogan "Mutualfunds *sahi hai*" and a website dedicated in that name in order to propel investor interest. The endorsements urge investors to look at mutual funds from needs as varying as children's education to retirement planning.

In line with the market structure, large-cap funds dominate the landscape ably supported by other categories as well. While we have thousands of mutual funds to choose from, the following data pulled from Reuters for equity funds with more than 10-year history is interesting to watch.

Equity Fund Categories, M-Cap-wise

Category	Number of Funds	AUM (₹ in bn)
Large Cap	24	1,441
Multi Cap	21	1,163
ELSS	29	870
Large and Mid Cap	20	539
Mid Cap	4	146
Total	**98**	**4,159**

Note: Only funds with more than 10-year history. Source: *Reuters*

It is indeed heartening to notice the explosive growth of this key institutional investor category which is surely a sign of market maturity. Over the years, the number of fund houses, range of funds and systematic investment plans have burgeoned to spoil investors with choices. That's exactly where the problem starts.

In this context, I am raising some key questions that may concern investors and try to answer them.

Do funds generate alpha?

Alpha is simply defined as excess return over the stated benchmark. Fund managers are paid management fees in the hope that they will perform better than the overall market (benchmark). In order to smoothen alpha calculation, we take five-year rolling annualized return (also known as Compounded Annual Growth Rate or CAGR) and deduct five-year rolling annualized market return to compute alpha. In general, we find that more than 50% of fund managers generated alpha during the period 2015-2020. In some categories like mid-cap, it can be even higher. The top alpha generators category-wise are given in the Table below.

Is there a Persistence in Performance (PIP)?

We are all familiar with the small print "past performance is not indicative of future results" and the superfast audio that plays this slogan in TV advertisement! However, product push predominantly happens based on past performance. While we have seen managers generate significant alpha, whether they do it consistently is the question. In order to examine this, we ranked the top 5 performers each year and mapped them to see who stays and who gets out (called the churn). We can compute a PIP ratio that divides incumbents with new entrants to the top 5 list. In other words, if the PIP ratio is 60%, it means 3 out of 5 managers in that year were existing incumbents. If that ratio is 100%, all the top 5 managers were the same. High ratio implies persistence in performance. The Table above provides the PIP ratio category-wise.

It can be noted that the persistence factor has been coming down over the years for many categories, which implies manager churn among top 5 performers. This makes it difficult to bet on winners. The decrease in PIP ratio could easily be due to increased competition.

What's Your Fund's PIP?

Category	PIP Ratio (%) (Sept 2020)	PIP Ratio (%) (2014)
Large Cap	60	80
Multi-Cap	40	100
ELSS	60	100
Large and Mid-Cap	60	40
Mid-Cap	100	100

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M R Raghu
CFA, FRM, FCMA
Head of Research,
Kuwait Financial Centre

Is there a relationship between performance and market share?

The overall industry has grown nearly four-fold during the past five years. Given this hectic growth, it is obvious that some funds increase their share at the cost of others. Let us see who gained and who lost.

The gainers in the market share did that based on their alpha generation, while losers lost out due to negative alpha. The gainers need not be the market leader in that category but represent one that increased their share significantly. In the large-cap category, SBI Blue chip fund increased its market share significantly from 2.5% in 2014 to 15% in 2020 on the back of cumulative alpha of 9.4% over the benchmark. On the other side, HDFC Top 100 lost the market share from a whopping 31% back in 2014 to about 11% now. During this period, the fund's cumulative alpha stood at a negative 14%, explaining the loss in market share. It should be noted that the fund's overall AUM did increase during the period 2014-2020 at an annualized clip of nearly 9%, still it lost market share. Among the losers in terms of market share, HDFC Funds represents three categories, while

Top Alpha Generating Funds, Category-wise

Category	Fund	Cumulative Alpha (%) (2014-2020)
Large Cap	Axis Bluechip-Growth	63.7
Multi Cap	Quant Active-Growth	53
ELSS	Quant Tax Plan-Growth	68
Large and Mid Cap	Mirae Asset Emerging Bluechip-Growth	72
Mid Cap	Taurus Discovery (Midcap)-Rgr-Growth	34

Market Share Performances: Who Gained and Who Lost

Category	Fund	Significant Gainer		Fund	Significant Loser	
		Current Market Share (%)	2014 Market Share (%)		Current Market Share (%)	2014 Market Share (%)
Large Cap	SBI Blue Chip Fund-Growth	15.3	2.5	HDFC Top 100-Rgr-Growth	11	31
Multi Cap	UTI Equity-Growth	9.8	2	HDFC Equity Fund-Growth	15.8	36.4
ELSS	Axis Long Term Equity Fund-Growth	25	12	HDFC TaxSaver-Growth	7.6	17.5
Large and Mid Cap	Mirae Asset Emerging Bluechip-Growth	21	3.6	Nippon India Vision-Growth	4	25.6
Mid Cap	Kotak Emerging Equity Scheme-Growth	51.5	5	Nippon India Growth-Growth	48	94

Note: Market share is based on our sample set of funds with over 10 years of data history in Reuters.

Nippon represents the other two. On the other hand, the gainers are diversified funds like SBI, UTI, Axis, Mirae and Kotak. Increasing market share in an increasing pie size is a significant feat indeed. Losing market share in an increasing pie can still mean period-on-period growth. In the multi-cap category, UTI Equity Growth fund increased its market share from 2% of total AUM to nearly 10%, while its cumulative alpha during the period 2014-2020 stood at 22%. On the other hand, HDFC Equity Fund-Growth lost its market share from 36.4% to 15.8% with a cumulative negative alpha of 17%.

In other categories too, we can clearly see a correlation between AUM growth, increase in market share and alpha.

Are there any exceptions?

While we see a clear correlation between performance and growth, we also notice some inconsistencies where poor performance is accompanied by strong AUM growth and vice versa. For example, in the large-cap category, while Edelweiss large-cap fund has shown a cumulative alpha of 10.5% over the period 2015-2020, its AUM level and growth remained tepid. At the same time, as we notice, Nippon India large-cap fund's AUM grew at a CAGR of 57% although it had a negative cumulative alpha of 9%. Across the board, we find inconsistencies where some funds clocked good AUM growth in spite of negative alpha. This could be due to aggressive selling. However, cases of good performance accompanied by poor AUM level/growth look strange.

The takeaway

In the final analysis, we find that mutual funds significantly outperform the underlying market, a fact that makes them a viable investment option. However, we observe wide variation in performances between leaders and laggards, raising a large question as to whether there is a persistence in performance? Our research shows that the persistence aspect has come down over the years, making it difficult to bet on winners. It is instructive to see who is gaining market share and who is losing, and correlate that with their performance.

Generally, we observe a strong correlation between market share gain and alpha generation, although there could be exceptions. Hence, it would be a good investment strategy to bet on market share gainers with good alpha generation history. ■

Reference # 20M-2020-11-13-01