

HOW TO IDENTIFY WINNING MUTUAL FUNDS

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How to Identify Winning Mutual Funds

The idea for this post came from a question a reader asked me during last Friday's Facebook Jam (See here – <http://on.fb.me/JBOxl0>). Since a lot of you must be interested in this topic of identifying good mutual funds, I started writing it for the next issue of *The Safal Niveshak Post*.

But I dived so deep into the subject, it ended as a full-fledged, downloadable pdf, which you now have in front of you. 😊

Anyways, let me start with some important facts...

- Mutual funds are big companies that manage the savings of small investors.
- Mutual funds are the best means to invest for the long term in the stock market.
- Mutual funds can help small investors beat the market.
- Fund managers are the smartest men in the stock market.
- You can never lose when you invest in stocks that mutual funds own.

Now for the most important fact – **Whatever I've written above is all wrong!**

While these may have been the guiding principles that the founding fathers of mutual funds must have written, none of this is true of the industry anymore...at least that is what my nine years of experience as an investor and a close observer of the mutual fund industry suggests.

The hard hitting, and honest truth is...

- Mutual funds are big companies, but they don't *manage* the savings of small investors. Fund managers working for these funds manage the money.
- Mutual funds rarely invest for the long term. In fact, most rarely 'invest'...they 'trade' in stocks.
- More than 75% of all equity mutual funds have underperformed the stock market over the past five years.
- Majority of fund managers are *not* smart, but like rats in a rat race...they are running to a place where everyone else is running.
- Stock selection in most mutual funds is a mockery. Don't ever follow them blindly.

Coming back to the first point above, most people believe that a mutual fund is a big company, which employs thousands of people, and manages the savings of small investors.

Indeed it is true that mutual funds are big companies employing thousands of people.

But then, as I also mentioned above, mutual funds *don't manage* your money!

The fund managers – people like you and me – manage your money.

And like you and me, these fund managers have their blind beliefs, biases, and other brain defects that rarely allow them to make smart, profitable investment decisions.

See, I'm not here to deride the fund management industry or the mutual fund profession. In fact, I believe mutual funds are a great concept for small investors.

But what I'm trying to do here is clear some widely prevalent myths surrounding the industry and how you – the investor – can stay clear of them (the myths) and make wiser, educated investment decisions.

So, as I was saying, even though a large part of the stock market money in India is in the hands of mutual funds, they do not make investment decisions – the fund managers working for them do.

And these fund managers have their own interests and agendas, some of which may not even be in line with the funds for which they work...forget being in line with your interests!

I won't blame the fund managers entirely for this. Of course they are consumed by their own greed to earn their salaries and bonuses, but their actions are also guided by the entire incentive system of the mutual fund industry.

So a fund manager, whose fund loses 40% market value in a stock market crash while other similar funds lose 50% market value, will still be called an 'outperformer'...and might receive a handsome bonus for the same!

And when the same fund manager earns a 20% return the next year, when the stock market is up 25%, he will be termed an 'underperformer'...and might not receive his annual bonus (and even have a chance of losing his job)!

This is the reason most fund managers always try to take the 'safer route' – they try to do exactly the way other fund managers are doing.

The reason for this is that if a manager's fund suffers in a bad market, he can claim, "But everyone else has also had a bad year! So why blame only me? The market is to be blamed!"

Funny, isn't it? But that's the way the industry works.

As Seth Klarman wrote in his seminal book on investing, *Margin of Safety* – *"If interplanetary visitors landed on Earth and examined the workings of our financial markets and the behavior of financial market participants, they would no doubt question the intelligence of the planet's inhabitants."*

Anyways, despite this behaviour, you have to pay around 2% annual fee (on an average) to mutual fund companies for managing your money (this fee is deducted from your investments every year, and is termed 'expense ratio').

If a fund has fees of 2% and only 'matches' the market's return with its stock picks before paying those fees, then you'll end up with a return that is 2% less than the market's, year after year.

Although 2% may not sound like a big deal, it represents more than 10% of Indian market's last 10-years' average annual return of around 17.5%.

Put another way, over 25 years, a Rs 10,000 investment will compound to Rs 5.7 lac at 17.5% returns per year, but to only Rs 3.7 lac (or 35% lower) at 15.5% per year!

Oh, now what?

Given what I just discussed above, you must pick your mutual funds carefully. For the most part, picking a fund is just like investing in individual stocks. And there are some funds – or, more precisely, some fund managers – whose services are worth paying for, because they are superior investors who won't take your money for a ride.

How to pick a winner mutual fund

Here are some guidelines you can use to identify good mutual funds for your portfolio...

1. Look for the marathon men

Typically, when the stock market is doing well, new funds flock to the market. That means many funds are relatively new, thus lacking any kind of long-term track record to judge them by. This alone should make you cautious.

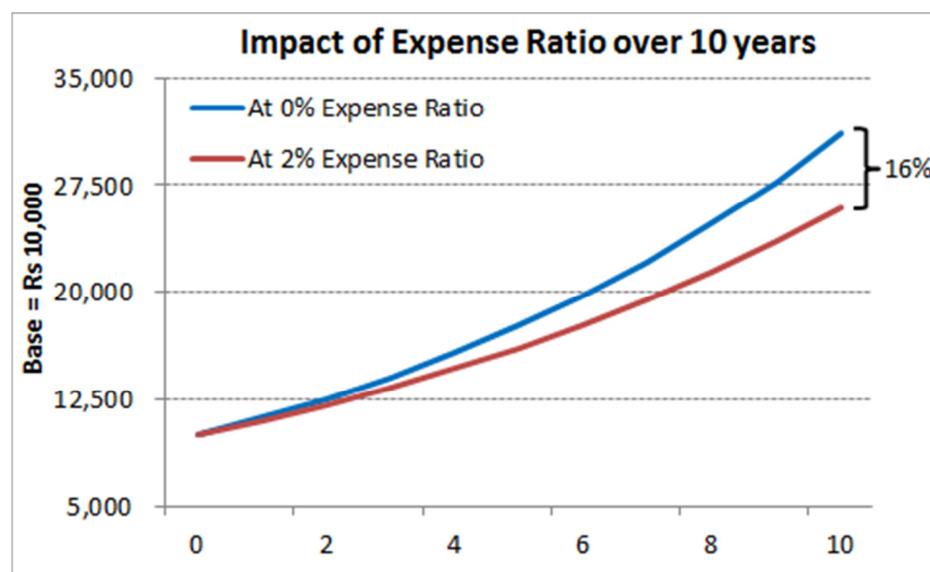
You must thus always look for funds with track records spanning both positive and negative market environments, which is generally true for funds that have been around for at least 10 years.

Don't even look at funds that have done well in the short-term, because their returns are exactly that – short-term. Long-term returns are most predictive of future performance, and thus you should look for funds that have been around for a significant amount of time and have a good track record to draw on.

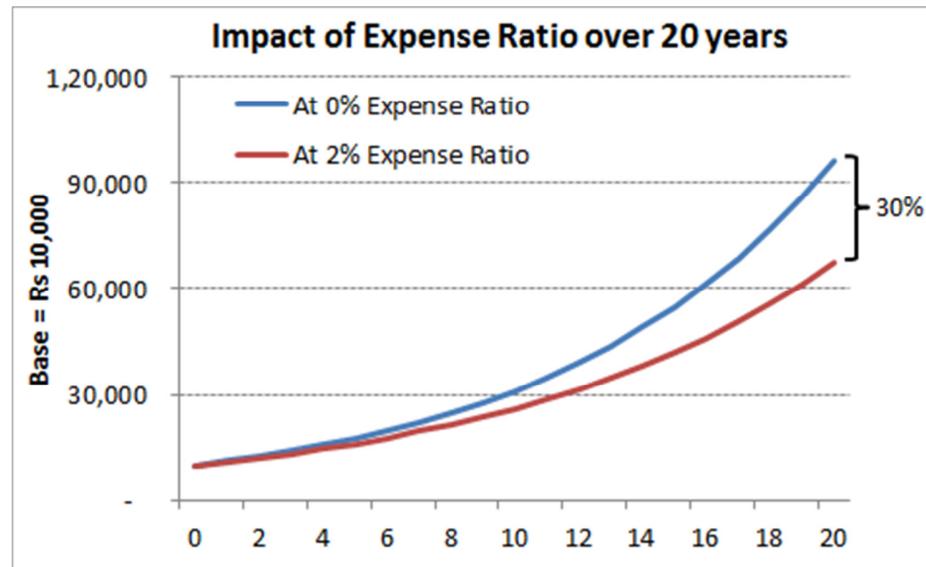
2. Look for the 'cheapskates'

As I showed above, mutual fund management fee (expense ratio) can eat a lot into your long term return. Thus it's important to find low-cost funds.

Here is a chart that shows the impact of 2% expense ratio on Rs 10,000 invested over 10 years...



And here is a chart that shows the impact over 20 years...



So the longer your tenure, the greater will be the impact of expense ratio on your investment. The sad part is that you cannot escape this. You have to continue to pay for the underperformance and eccentricity of fund managers.

Anyways in India, for an equity mutual fund, the expense ratio cannot be more than 2.5% of its average weekly net assets. For debt funds, the ceiling is 2.25%, while for index funds and fund of funds, the expense ratios are capped at 1.5% and 0.75%, respectively. Clearly, cheapness alone doesn't guarantee success – but it one of the necessary conditions for long-term success. Anyways, while inexpensive funds should be a crucial aspect of your mutual fund search, you shouldn't make cost your only criterion.

3. Look for the best managers

I give a lot of weight to fund managers while searching schemes for my portfolio. Here are three thumb rules I follow to search for good fund managers:

1. I prefer managers who have been investing for years, if not decades, instead of with managers who are still learning on the job. This helps me ensure that the manager has been on the job in both bull markets and bear markets.
2. I try to find the manager's performance over the long haul (usually 10 years) with the same fund, and how well he has outperformed the markets during this period. Of course, any manager can have 1-2 great years, but consistency is what you must look out for.
3. My third criterion for finding a good manager is to understand whether he has been using the same investment philosophy throughout its history or not...or does he change his stripes to fit the latest investing fad. I don't want a manager who tries to be all things to all investors and at all times.

While I have no data (except my experience) to back my claim for a 'long-serving' fund manager in India, research done by Standard & Poor's in the US has proved that a fund manager's tenure with a specific fund is one of the most important reasons for its success.

Yet, this factor is often overlooked by investors rushing to buy funds with the highest short-term returns.

Simply put, funds with long-term management structures outperform their peers, and a change in management is one of the biggest reasons to consider selling a fund (I hope you got a hint here for a fund house that recently sold out to another ☺).

4. Look for the slow turners

Like excessive trading (buying and selling... buying and selling) can cut short your returns from stocks, it has the same impact on mutual funds.

Of course, mutual funds are sometimes forced to buy and sell stocks to take care of sudden inflows and outflows of funds, a consistently high turnover of stocks by the fund manager eats into your investment returns.

The inverse of a fund's 'turnover ratio' is the average holding period for a stock in that fund. It is derived by dividing 100 by the turnover ratio. So, a fund with a portfolio turnover of 50% would hold a stock for 2 years on an average.

Now check this out – the average portfolio turnover of all diversified equity mutual funds in India is around 60%. What this means is that an equity mutual fund, on an average, holds a particular stock for just about 1.6 years, or 20 months!

And there are some funds whose turnover rates are as high as 250% and 150% – or average holding period of 5 and 8 months respectively!

So much for the fund managers and their salesmen coming on TV and asking you to invest for the 'long term'.
Huh!

Now the question is – how do you know whether your mutual fund's turnover is reasonable? See, there's no magic number, but for large-cap funds, you generally want to beware of funds with more than a 40-50% annual turnover rate. Of course, some fine funds may have turnover higher than this range in 1-2 years and yet still perform well. Just make sure you know that these funds may incur extra trading costs.

As far as mid-cap and small-cap funds are concerned, they tend to have a slightly higher turnover than their larger-cap cousins do. Turnover of 120%-150% is common here, but watch out for anything greater over a longer period of time.

All in all, know that excessive turnover over a long period of time can eat away at your investment returns. The turnover ratio may not be one of the first factors you must review when finding or evaluating funds, but it shouldn't be ignored as well.

5. Look for the old-fashioned

Another factor to look for in a well-performing mutual fund is whether it has stuck to this winning strategy for long or not. That sounds simple, but many funds have a lot of trouble sticking to a core approach.

Perhaps the most common reason funds stray from a winning strategy is that their own success makes it difficult to keep doing the same thing. A large cap fund may find itself tempted to buy small cap stocks (or vice versa) when large cap stocks aren't doing well. Domestic funds may want to buy international stocks, and vice versa.

As a policy, I stay away from thematic/sector funds because even when a sector is poised to do poorly in the future, the fund will have to remain invested in the relevant companies. Or else, out of frustration, the fund manager might try to do foolish things and look across the border, to stocks from other sectors.

I remember a leading technology fund in 2000 buying Zee TV just before the dot com bust (and Zee's stock was 'hot' then), while suggesting that media was 'also' technology. Then, in the next boom, Zee was part of many FMCG funds because the company was expected to benefit from the consumption boom. Great understanding, sire...but thank you!

All in all, look for funds that have stuck to their strategy for a long time in the past, across good and bad markets, and have still done well. Avoid the ones that go with the latest fad.

6. Look for what your gut is telling you

Now this is very important! After analyzing mutual funds using all the above parameters, understand what your gut is signaling at about the fund's quality. If you still have any doubts, it's better to pass on the fund and find another (or to study it again). The more you perform this kind of research, the more you'll improve your skills in identifying the next winners.

Summing it all up

There are thousands of mutual fund schemes in the market – more than 3,000 – a frightening number. Who has time to spend hours researching even a small number of them?

Fortunately, knowing *what to look for* (and thus *what to avoid*) can significantly reduce your research time, and lead you to the winners. (Here is one resource I like where you can start researching mutual funds – <http://www.morningstar.in/funds.aspx>)

But before you do all this, determine your investment objectives. Know what is your investment goal – preserving principal, generating income, paying for a child's education, or saving for retirement?

Then choose mutual funds whose objectives are in line with your goal(s).

But don't ever buy a fund because your brother-in-law, or his friend, or his girlfriend, or her advisor advised you to buy it. Do your homework and own the responsibility of choosing the best for yourself.

It's your money, isn't it?

Anyways, I am not done as yet! 😊

Buy good funds, but don't hang to bad funds

There's a big psychological reason for investors holding on to their bad funds even after realizing their mistake: Most investors hate to sell at a loss.

The thought goes like this – "Sure, my fund is down 20%, but if I can only hold on until I break even, then I'll sell!"

People hate to admit they made mistakes, and they tend to hold on in hopes of eventually justifying their purchase.

I suggest you don't fall into this trap. If your fund no longer meets the initial criteria (like a small-cap fund starts investing in mid or large cap stocks) for which you bought it, cut your losses and move on.

Regular fund monitoring needs to be a part of your investment strategy. It's not enough to find a handful of good funds, and then sit back and put your portfolio on autopilot. You need to ensure that your fund managers are still delivering all the performance they promised you.

But don't just sell a fund just because it has had one bad year! Even good funds will have a bad year here and there.

If you sell of them based on just one year's performance, you may very well miss any recovery the fund experiences.

Unfortunately, it's impossible to pinpoint exactly when you should sell a fund for bad performance. But generally, one bad year isn't reason enough to sell. Consider the performance in the context of the market environment, and use that analysis in your decision.

Now, if a fund does badly (underperforms other similar funds) for two straight years? Maybe it's time to think about selling. Three years? Probably, you must sell!

Anyways, apart from bad performance, one more reason you can sell your fund is when its manager leaves. While it's difficult to predict how the fund will perform under a new manager, know that even if the new manager has a vast amount of experience, he doesn't have an established history of managing that particular fund. What this means is that you can pretty much kiss its prior track records goodbye.

A new manager can certainly do as well or better as the one he replaces. But what I'm trying to say here is that when a new manager takes over control of a new fund, past performance no longer becomes a valid factor in judging whether a fund's worth keeping.

Know someone who would benefit from this E-Book?

I hope you enjoyed reading this E-book and got the value that you expected of it.

Now I'd like to ask you a small favour.

Provided you've liked what you've seen in this E-book, kindly share it with your friends and colleagues who might be interested.

You can also invite them to sign up for my free E-letter on investing and personal finance – ***The Safal Niveshak Post.***

You can also send them to sign up for my free 20-lesson course on Value Investing – ***Value Investing for Smart People.***

...or the upcoming course on Financial Planning – ***Financial Planning for Smart People.***

Thank you again for being there!

About Safal Niveshak

Safal Niveshak is a movement to help you, the small investor, become intelligent, independent, and successful in managing your investments and personal finance.

My name is Vishal Khandelwal, and I am the founder and chief tribesman at *Safal Niveshak*. Before starting work on the idea of *Safal Niveshak*, I was working as a stock market analyst for eight years.



During this period, I felt the pain of seeing small investors lose large amount of their hard earned money, for reasons ranging from:

- Scams...where companies simply vanished, to
- Speculation...to earn fast money, to
- Bad decisions...mostly backed by insensible and short-term advice from self-centered brokers and self-proclaimed stock market experts.

While the probability of a stock market analyst to work on a social cause is miniscule, here I am driving this movement called *Safal Niveshak* – to help you become intelligent, independent, and successful in your stock market investing decisions.

Through my experience in the stock markets, I have come to believe that:

- You alone are the most capable person alive to manage your money.
- Investing in the stock markets is not a rocket science. You just need to form the right habits, and behave yourself.
- Being smart about your money can be a lot of fun.
- You can create a lot of wealth for yourself doing it.

You can write to me at vishal@safalniveshak.com to know more about this initiative and how you can benefit from it and/or support it.

With respect,

Vishal Khandelwal

Founder & Chief Tribesman, Safal Niveshak