DHFL Pramerica MUTUAL FUND

A conversation with a WKEFM

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My flight was delayed and I chose to wait in the airline lounge at the airport. I was feeling a bit depressed because of the stock market's recent correction. I found that the lounge was nearly full, and only one place was empty. To my pleasant surprise, one of the most well-known equity fund manager (WKEFM) was sitting next to the empty seat. As luck would have it, I sat next to him. To my surprise, he was open to a conversation, and after a while became quite chatty. The following was roughly our conversation that evening:

Me — Hello Sir, it is a pleasure meeting you and to talk to you. I have been both a fan as well as an investor in your fund for more than 2 years.

WKEFM — Thank you, that's nice. Have a seat.

Me — If you don't mind, Sir, I would like to ask you some questions. It is not often that we get to meet a WKEFM like you on a one-to-one basis.

WKEFM — Sure, please go ahead

Me — Thank You Sir. I have made some good money over the last 3 years in several funds that I had invested in, but now I am slightly frightened by a few things like this recent correction, and the re-imposition of capital gains tax. So, Sir, my question to you is – how does the market look now?

WKEFM — It could go either way. There are positive points to talk about, but looking at the way some parts of the market, and some sectors have risen, a further correction might be possible, even welcome.

Me — Sir, are you telling this because you don't want to speak openly?

WKEFM — No boss. I am being frank.

Me — Isn't a fund manager supposed to know how the market would move? After all, that's your job.

WKEFM — Please don't fall for this. A fund manager can assess the positive and negative factors that might determine the market's movement. But no fund manager can predict when the market can go up, or down. The same is true for individual stocks. **The stuff that you see in the business channels on television is the speaker's estimate of what would happen.** That's all.

Me — Can you please explain, Sir?

WKEFM — See, the movement of an individual stock in the short term is determined by literally hundreds of variables. It is driven by the sentiment of thousands of investors, and sentiment is in turn driven by many variables. It can be political events, reactions to some national or international news, natural disasters, a stiff statement made by a cabinet minister, RBI governor or any monetary authority in any major economy of the world. In addition, it can be the news of a scam, or it can be movement of currencies or commodities. We simply cannot control, or attempt to predict these things all at once.

Me — So why predict, Sir?

WKEFM — Because we are expected to. The real reason, I believe, is that most investors want to invest only in a market that is rising. In a falling market, many people believe that they would like to stay away until they can predict when the market would begin to rise again. And as a supplier of investment products, I am supposed to predict just that.

Me What's wrong with that, Sir? Isn't efficient use of capital what the capital market is all about? If we know that the equity market is going to give negative returns, we might as well stay away from it and come back when we sense that the market would rise again. In a falling market, I would like to invest in fixed income.

WKEFM The most important word you just used was **"if"**. What saddens me as an investment professional is that too much effort is wasted in trying to predict when the market is going to rise or fall. Are you aware of anyone who has correctly predicted this consistently?

Me No Sir.

WKEFM Besides, why does one think that a falling market is unnatural? Just as in breathing, inhalation and exhalation are both natural processes, a rise and a fall are both natural phases of a market. The market will fluctuate. That is what it is supposed to do. A fall isn't necessarily bad. It is bad only if you permanently lose your money. Don't waste your time trying to predict each fall. None of us can do it.

Me How do I protect myself against a permanent loss of money, Sir?

WKEFM For one thing, choose investment products on the basis of whether they are **GOOD**, and not on the basis of whether they are the **BEST**. Secondly, have a reasonable amount of diversification, but do not overdiversify. Finally, ensure that there is appropriate asset allocation that is based on **your and your family's requirement**, and not on the basis of what your neighbor is doing. Your investment advisor's role is critical in this asset allocation decision, so make sure you get the right one.

Me That's an interesting observation. Why do you suggest that we don't seek out the best, and why are you suggesting that each product should be different from one another?

WKEFM To answer your first question, it is because the "best" is usually defined as the investment product that has given the highest return in the immediately preceding 12 months (in some cases, 3 months). On this basis, have you seen any investment product consistently remain in that position?

Me Come to think of it, No Sir. As a matter of fact, I chose to invest in your fund 2 years ago because it was close to the top at that time. I must say that I am disappointed this year that your fund is ranked in the 3rd quartile.

WKEFM Just try and make a list of top performers in each of the previous 10 years. I bet that you would find 10 different names. Also tell me friend – you said that you bought my fund 2 years ago when it was close to the top. Did you ever consider buying into my fund 3 years ago?

Me No Sir. 3 years ago your fund was close to the bottom.

WKEFM Correct. But if you had bought my fund 3 years ago, your compounded return over the last 3 years would have been much better than a single-year return that my fund has generated last year. Carefully think about this – is it better to buy a fund before it starts to do well, or after it has done well? When will you make more money?

Me Well Sir, I suppose it is before the fund starts to do well.

WKEFM Precisely. But how many time are you willing to buy a fund when it is close to the bottom of the pack?

Me I wouldn't dare to do that Sir. Who wants to buy a product that underperforms?

WKEFM Friend, your investment performance over a period of time is bound to be mediocre if you keep this attitude. What you will keep doing is to buy funds **AFTER** they have done well, and keep getting disappointed that they are not the best products. It is time that we all accepted that there is no investment product, anywhere in the world, that has consistently been at the top.

Secondly, it is also time that we accept the fact that we are incapable of correctly predicting, each time, which investment product would do well over the next year.

But the most important point is, **YOU DON'T NEED TO CORRECTLY PREDICT THIS**.

All that is needed is that you choose a set of products that are good, and not expect them to be the best. Secondly, as I have already told you, ensure that they are reasonably different from each other. Thirdly, also as I have already told you, just remain with them after carefully choosing them.

The advantage you have over choosing good products rather than trying to get the best is – you can have several good products simultaneously, but you can have only one best product (and the best keeps changing).

Me How do I spot a good product, Sir?

WKEFM A good investment product would have the following characteristics

(a) It remains faithful to the mandate of the product. In other words, it does what it is supposed to do. I am not talking about the returns it generates. I am talking here about the approach to investment followed. The recent re-classification by SEBI is a step in the right direction to ensure that all investment products do what they are supposed to do.

(b) There are no blatant red flags in the portfolio. Again, your investment advisor would help you with this.

(c) Try to see the investment performance on an annual basis, and do not see CAGR returns at a particular point in time. A fund can have an extraordinarily good single year's performance, and if seen at that time, both the 3-year and 5-year performance would look good too.

(d) Better still, try to see rolling 3-year returns every year, if you can get hold of that data.

(e) Above all, there is a logical investment process that is followed, and consistently so. The buy-and-sell decisions are not done whimsically.

For all of the above, the inputs and research of your investment advisor would be vital. Not many investors can study these things on their own.

Me That's useful Sir. But why did you say that each product in my portfolio should be different from one another?

WKEFM If they have similar portfolios, they would rise, and fall together. The whole idea of diversification is to reduce risk.

Let them be different from each other. That means that they will have different trajectories of returns. That way you are increasing your chances that at any given point in time, at least one of your funds would be doing well. If all your funds had similar portfolios, and they all did badly together, that's not such a good thing, is it?

Me You also said that after choosing a set of products carefully, I have to stick to them. Can I not get better returns by switching from one product to another and invest only with the more efficient ones?

WKEFM From hard experience, I can tell you that **the most important ingredient in this business is TO BE TRUE TO ONESELF**. Do not lie to yourself. Can you correctly predict which fund is going to be at the top over the next one year, and the one that is going to be at the top the year after next, and after that?

It is highly unlikely. Therefore, don't try to do it.

Just have one good Large Cap Fund, one good diversified / balanced fund, one good Mid-cap Fund. If you have surplus beyond this, you can choose one good PMS. Ultra HNIs can choose two of each. These together should meet more than 90% of the equity needs of almost everybody.

Some of them would underperform at some time. But that's better than trying to be too clever by half and losing your money permanently.

Me Speaking of underperformance, Sir, do you like it when your fund underperforms?

WKEFM Are you kidding? Of course, I don't like it. **But the point is, in my job if I try to do it on a daily basis, or on a continuous basis, then I am heading for trouble**. Especially so in a wildly bullish market. Have you seen what happens to the stocks or funds that are "outperforming" at a time when the market indices' valuations are at historically high levels? Have you seen what happens to such funds after a sharp correction? Many of them never recover fully after that. We have seen this happen in 2000 after the Technology boom, and in 2008 after the Infrastructure/Real Estate boom. And speaking of "outperforming" a benchmark Index, my job has just become harder after the Industry has made the Total Return Index the benchmark for measurement, rather than the Price Index.

Me Why, Sir?

WKEFM A price index is always ex-dividend. On a long-term basis, the Nifty 50 Index has had a dividend yield of about 1.4%, and the Nifty 500 Index has had a dividend yield of about 1.6%. The fund has the benefit of this dividend yield but a price index does not. This is added to the Total Return Index benchmark, and my fund must beat the benchmark by more than 3% per annum merely to keep up with the Total Return Index.

Me Can you please explain this, Sir?

WKEFM Well, an average equity fund has 2.5% expenses. Add GST to it, it comes to nearly 3% assuming the market keeps rising over the long term. Since the NAV is post expenses, the portfolio must beat the Index by 3% just to keep up with it.

Me I see. So, you are saying that no fund is going to beat the benchmark Index henceforth.

WKEFM Boss, I am NOT saying that. But the job has become more difficult. No doubt about it. But it can be better handled if we all work together. The AMCs, the distributors and investors like yourselves.

Me How, Sir?

WKEFM Well, for a start, please look at this table that I compiled from the Value Research website. (At this stage he showed me the following table:)

Time Horizon	(% of active funds outperforming the respective benchmarks)		
	Large Cap Funds	Multi-cap Funds	Mid-cap Funds
5 years ending 31/12/2017	88.00%	94.00%	82.00%
3 years ending 31/12/2017	92.00%	85.00%	33.00%
1 year ending 31/12/2017	67.00%	78.00%	22.00%

Benchmark Chosen

(1) Nifty 50 for Large Cap Funds

(2) BSE 200 for Multi-Cap Funds

(3) Nifty Midcap FF 100 for Mid-cap Funds (Data Source: www.valueresearchonline.com)

From this data, you can observe that a greater proportion of actively managed funds beat the price benchmark over a 3-year and 5-year time horizon rather than a 1-year time horizon. This is especially true for multi-cap and mid-cap funds.

It surely helps the industry, and therefore the Fund Manager, if this is understood and implemented.

If I am to beat the Index, will I be able to do that if my portfolio mimics the index?

Me In that case you will replicate the Index returns.

WKEFM No. The NAV movement would be lower than that, because of the expenses involved.

This is a bit like planting a seed. But for this to work, you must allow the portfolio to grow. If you want me to constantly outperform, you allow no time for the seed to germinate and grow. I did say that nobody can predict **WHEN** the stocks would rise. We can, with a reasonable amount of diligence and intelligence, estimate **WHY** they should rise. Which is why, as an investor, you should pay attention to what is there in the portfolio, rather than just go by how much return the portfolio has generated in the past 12 months.

Me Sir, I can't do that myself. I would need help.

WKEFM Great. You have already crossed the first step. **You are being true to yourself** by admitting what you can and cannot do. Just extend this a little further and write down what you want to achieve from your investment program. Don't prepare vague plans like "making a lot of money". Specifically write down what you are investing for. Also, be clear about how much negative fluctuation in stock prices you are willing to withstand. That would determine the asset allocation that you would eventually decide upon.

It will lead you to the right investment advisor.

By this time, my flight was announced. I thanked the WKEFM and boarded my flight.

I must say that I felt better after this conversation, and it had nothing to do with the drinks that I had downed.

(The above passage is a fictional conversation between an investor and a fund manager. Although the characters are fictional, the ideas behind the conversation have arisen from the author's experience in fund management).

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