INDIAN EQUITY FUNDS NEED TO DEFINE ALPHA AND STYLE

ACCORDING TO PANELISTS AT THE HUBBIS INDIAN PRIVATE BANKING FORUM 2014 IN MUMBAI IN LATE AUGUST, EQUITY FUNDS NEED TO HELP ADVISERS AND INVESTORS BETTER UNDERSTAND RETURNS EXPECTATIONS.

Mutual funds in India don't give out return expectations, partly because regulators don't allow them to, and partly because they don't want to set high expectations.

However, in the absence of guidance for the future, investors and advisers end up basing their expectations on past track-record anyway. And they may switch funds at the first sign of under-performance relative to peers because they don't understand whether it's related to the style being out of favour or a longer-term issue.

Hansi Mehrotra, the moderator, postulated that while retail investors may invest in mutual funds to get access to the equity market, high net worth (HNW) investors can do so through cheaper routes such as ETFs. Or they can seek higher alpha through managed accounts. They choose to invest through mutual funds to get access to significant and consistent alpha. As a result, it's important for them to have an expectation about how much the alpha is likely to be and whether the alpha may fluctuate with market cycles.

Manish Gunwani, senior fund manager at ICICI Prudential Asset Management, said that estimating alpha is quite difficult, even for portfolio managers. Hence, his firm has focused on "communicating where products lie in in terms of deviating from the benchmark, and then being true to label".

As example, in the firm's Focused Blue Chip Fund, it has clearly stated that it will not deviate too much from the benchmark in terms of sector allocation.

On the other hand, the Top 100 fund doesn't have such restrictions. "Obviously, these restrictions will affect return and volatility, but we find it difficult to put a number to the alpha," explained Gunwani.

The median three-year rolling return for large-cap funds has fluctuated around 1% (after 2% fees) over five years. The panel was asked whether the private banking industry should therefore assume a 1% alpha going forward for large-cap equities. Similarly, should the alpha expectation be closer to 8% for mid cap, in line with historical alpha? Navneet Munot, chief investment officer of SBI Funds Management, said that one could estimate the alpha for

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Punam Sharma
IDFC Asset Management

"India's economic growth profile is better mapped by mid-cap and small-cap. So if you want higher alpha, you need to focus on this segment"

Indian equities funds. "Theoretically speaking, a large-cap fund has a tracking error of around 4%, then taking a 0.5 information ratio, the industry generates around 2% alpha, post 2% expenses, which is pretty decent." He said his firm, probably like most others, focuses on relative returns in large-cap and on absolute returns in mid-cap. "Investors look at absolute long-term returns rather than just the pure relative return, especially in markets like India," added Munot.

Meanwhile, Punam Sharma, head of research at IDFC Asset Management, provided a different perspective. "Mapping the entire market space, we have around 3,500 to 4,000 listed entities. While the large cap funds tend to benchmark sensitive and hence aim at 1.5% to 2% alpha, India's economic growth profile is better mapped by mid-cap and small-cap. So if you want higher alpha, you need to focus on this segment."

STYLE IS SUBJECTIVE

Mehrotra also steered the discussion towards style issues. The dispersion of returns in equity mutual funds is a result of different views and approaches to stock-picking – essentially style, which is basically a belief about what factors will add value over the long run.

Interestingly, most markets show value outperforming growth over the long run but there tends to be more growth funds than value funds, perhaps showing human nature to be biased towards positive stories. There is also a belief that in a growth market like India, value doesn't make sense. It also depends on how value is defined.

The panel appeared to be unanimous in concluding that fund managers tend to interpret the value/growth definitions differently, with statements from Sharma such as: "Value and growth are the components of the same investment process; value will be credited only if growth follows. Investors always look at earnings growth so it's always growth that you are valuing."

Even Parag Parikh, chairman and chief executive officer at PPFAS, which is known for a value style, admitted that he follows the Warren Buffet model rather than Ben Graham's cigar-butt approach. He said that his firm's process focuses on "understanding the business of the particular company, run by credible management". In India, he added, value can be destroyed by the management. "We have courts of law but no courts of justice," he said.

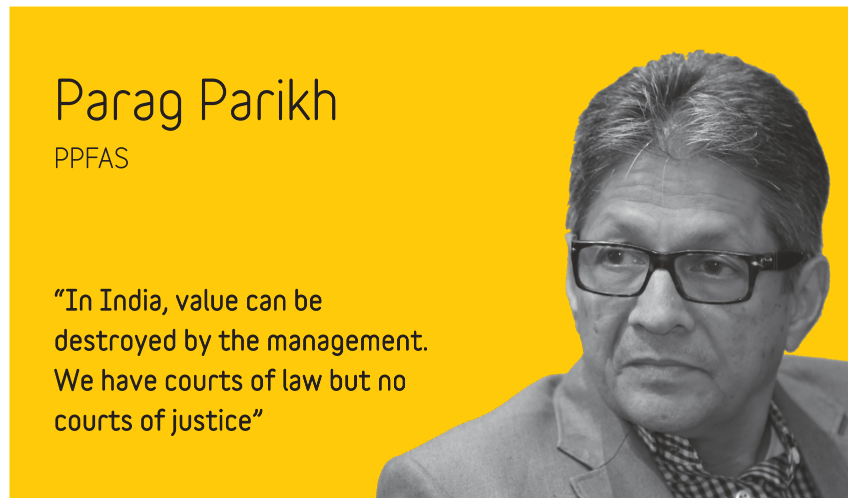
Munot said the traditional definitions of value include a low price-to-book or low P/E or high dividend yield but this doesn't apply in India. "In India, you have bond yields of 8% to 9% and dividend yields of 2% to 2.5%," he said. "Why would people buy dividend yields? Even while buying a high dividend yield stock, there is an implicit assumption of high growth in dividends. A pure value could actually lead to a value trap unless growth is built into the assumptions."

Manish Gunwani
ICICI Prudential Asset Management

"To perform on an absolute basis, you need to have flexibility in thought process"

He explained: "Quality is another dimension of value. By quality we mean a right-to-win, high-return on equity and high earnings growth. Of course, management is important but valuation is a second filter for us." He reiterated that, in India, quality investing is the one which works well: "If you get quality right then the value investing works well."

Mehrotra pointed out that communication about process and style is relevant so that advisers and investors can make decisions about how to respond to short periods of under-performance.



Parikh said that asset management companies (AMCs) should take a stand but that larger houses have become supermarkets, offering a large selection of funds and styles, leaving the decision to investors.

Munot added that so long as the fund style is articulated well, it's ok to have different funds offering them. He said the issue is that Indian investors treat fund managers like "Gods", believing they can outperform at all times.

Some AMCs have indeed taken the approach of adapting style to market conditions, trying to outperform at all times. "You think differently depending on whether you are benchmark or absolute return-focused," said Gunwani. "To perform on an absolute basis, you need to have flexibility in thought process. To add value to the benchmark, you need to incorporate a bit of all styles."

According to Andrew Holland, chief executive officer of Ambit Investment Advisors, the supermarket approach has landed the industry to benchmark. However, alpha could be enhanced by investing in a long/short strategy, he added. "In a long/short strategy, we don't mind if the market's going up or down, we aim to make positive absolute returns."

Parikh pointed out that markets tend to go up in the long run, and the scope for shorting is limited by the amount of stock available in the market. Hence shorting maybe going against the "universal principle".

Holland rebutted that argument, saying that unlike in the West, where people short naked positions, the long/short strategy has hedged short positions.

POSSIBILITY FOR SMART BETA

Mehrotra posed the question of whether the concept of "smart beta" could be implemented in India.

Munot said academic research has so far focused only on size, value and momentum as style or factors, but there is a fourth aspect to define style, based on liquidity. "If you divide the markets into liquid and illiquid stocks, you could earn an illiquidity premium in the long term," he said.

His view was that these opportunities are still being exploited by active fund managers rather than index providers.

Hence, he said, there are plenty of opportunities for active funds. ■

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