



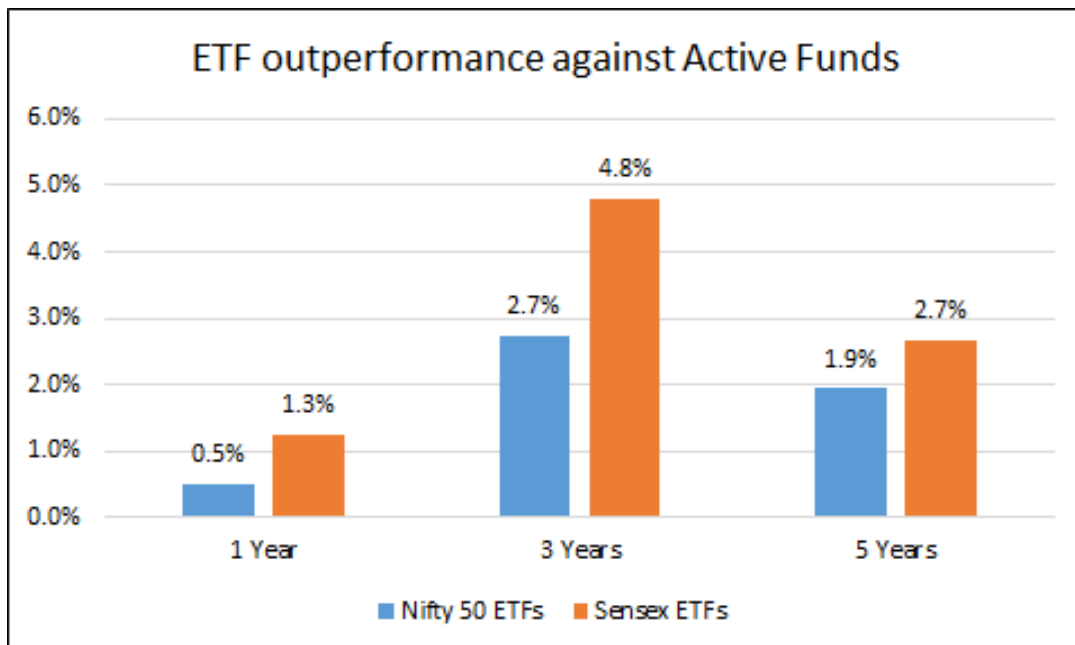
## In the age of passive funds

Point to Point vs. Rolling returns | Declining ability to outperform? | Consistency ratio

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In one of our earlier blogs ([Active vs. Passive and an Elephant in the Room!](#)), we had shared below chart. It indicated passive funds' outperformance against active funds over various time frames:



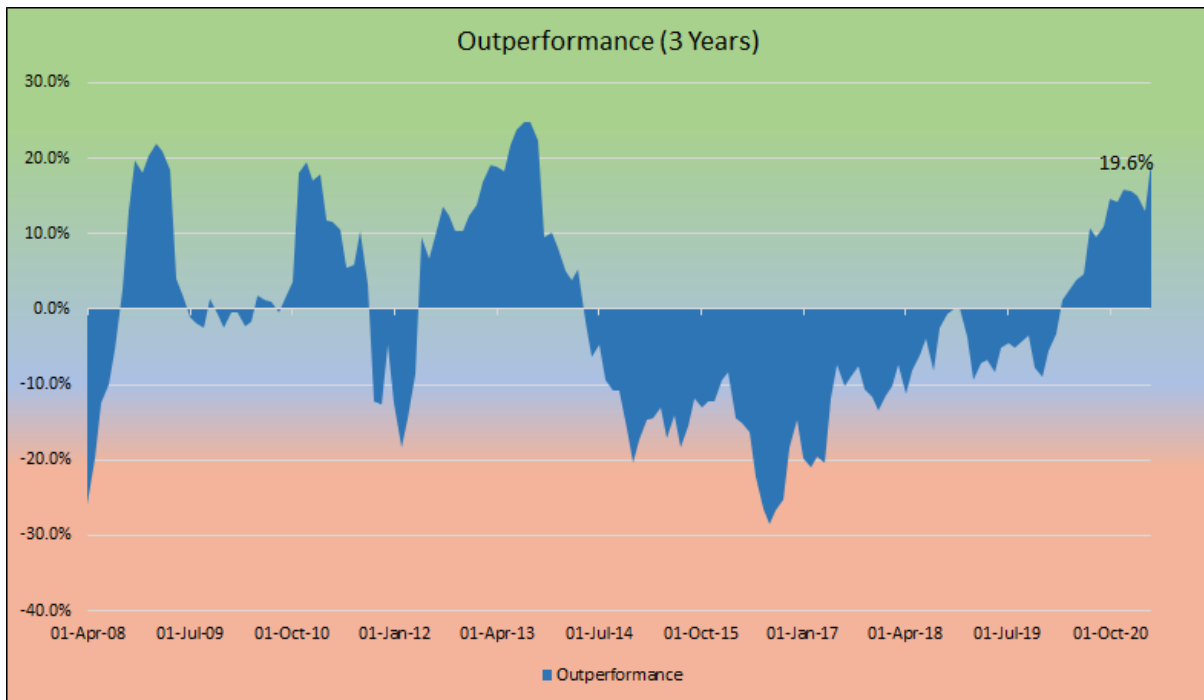
However, such point-to-point returns are also riddled with start and end point biases. It simply means that the days between which we calculate the returns, start date and end date, can impact the outcome significantly and even what we perceive about the funds or any asset class.

Let us look at one example with a leading equity fund.

	1 Year	3 Years	5 Years
Mutual Fund	171.7%	23.5%	16.0%
Benchmark	102.5%	3.8%	12.5%
<b>Outperformance</b>	<b>69.1%</b>	<b>19.6%</b>	<b>3.5%</b>

This mutual fund has outperformed well as compared to the benchmark across time frames. However, this is the situation as on today. But how has the fund been consistent in its performance?

For that, we will need to break fund’s outperformance history into various 3-year periods. 3 years can be considered as sufficient time allowance for any fund manager to demonstrate his or her skills.



This monthly rolling outperformance chart reveals few things which point-to-point returns fail to highlight.

The 3-year outperformance has not been consistent – there were times when fund beat its benchmark by whopping 20% and then times when it underperformed benchmark by almost 30%.

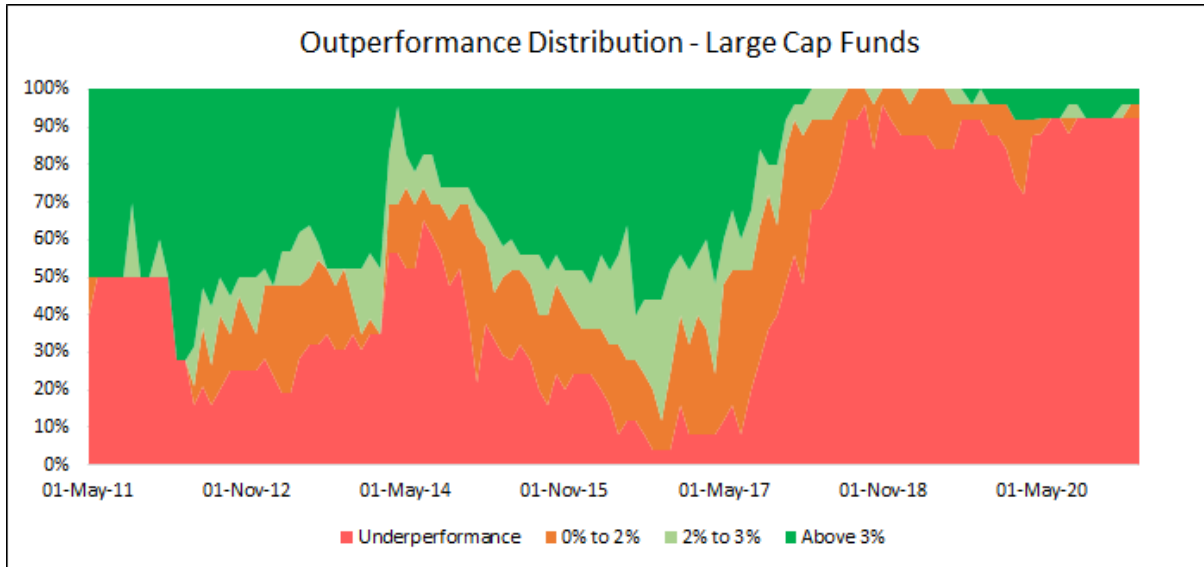
Thus, point-to-point returns hide the period of underperformance like 2014-2018. If we were to calculate similar point-to-point returns say somewhere around Jul 2016, we would have observed large underperformances instead of outperformance seen today.

In a nutshell, it is always better to use rolling returns than point-to-point returns to analyse any returns series.

Now keeping this in mind, let us see how do active mutual funds in general fare on rolling returns basis.

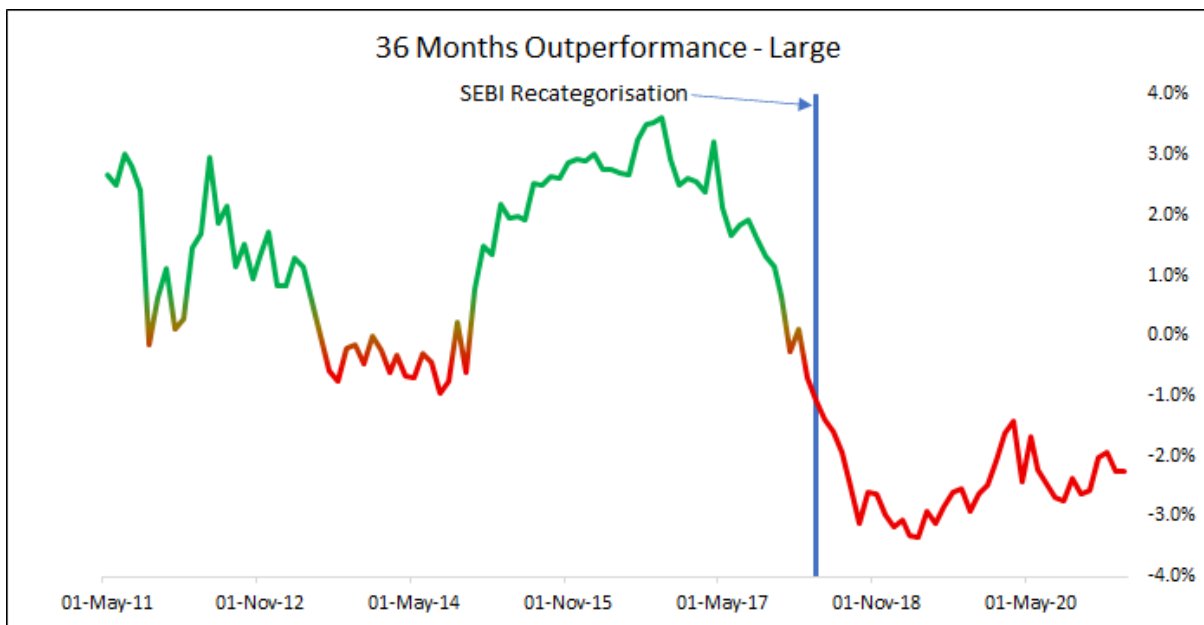
**Rolling Returns:**

We calculated outperformance of the major Large-cap funds against their respective benchmarks. 3 years returns and outperformance were calculated at the end of each month:



In Sep 2016, only one fund underperformed the benchmark out of total 25 funds considered. This is the month when the red area in above chart is the lowest (between Nov 2015 and May 2017) i.e., when almost all large cap funds outperformed.

However, the red area has kept on increasing since then indicating that large cap funds have found it difficult to beat their benchmark in recent times.

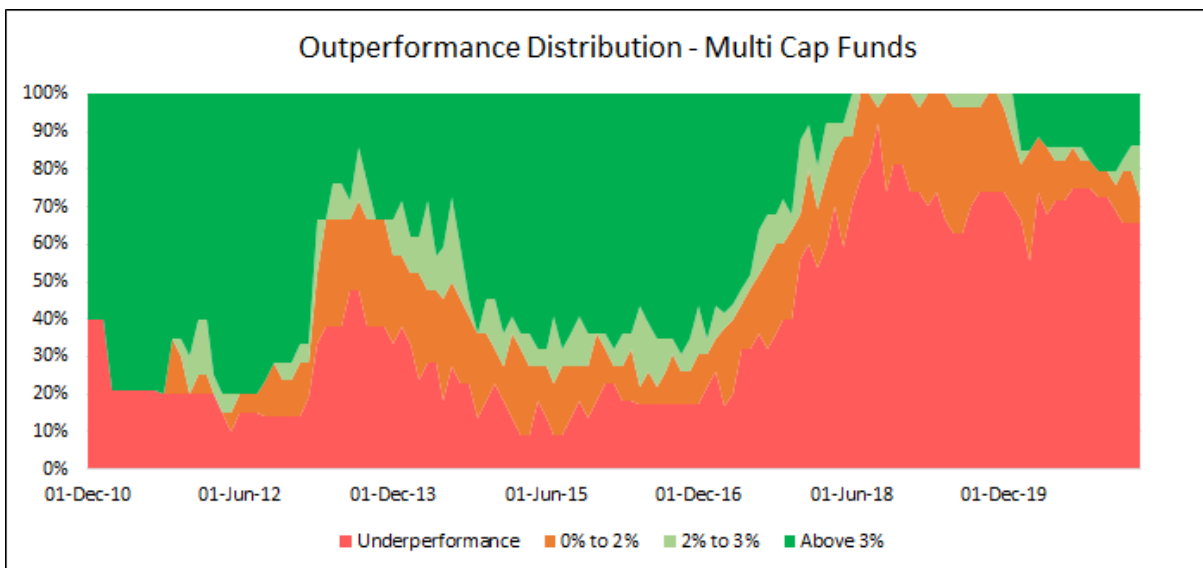
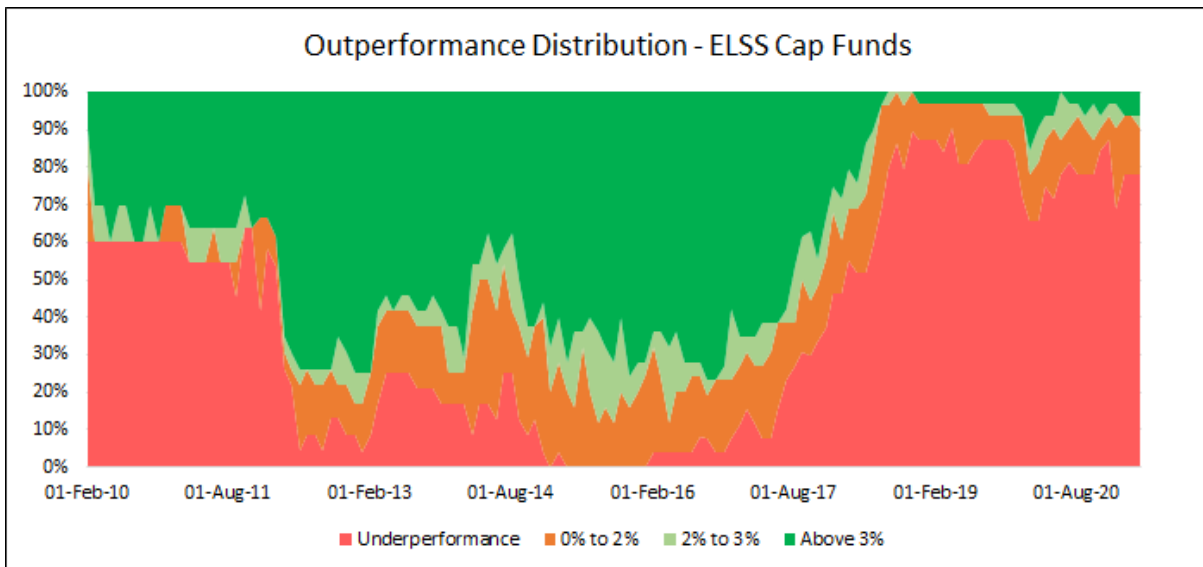


Median outperformance was also highest during Oct-2016 at 3.2%. However, it had declined consistently since then. It continues to remain in negative territory.

Oddly, such underperformance coincides with SEBI’s recategorization of mutual funds to ensure fund invests true to their mandates. There is a possibility that active funds are finding it difficult to outperform under new regulations that limits fund’s ability to move across market caps. It seems that funds are finding it difficult to generate alpha with 25 odd managers investing 80% of their AUM in same top 100 companies.

SEBI recategorization, however, did not impact some categories of funds like ELSS and Multi Cap in terms of their portfolio composition. Let us see the movement of outperformance for these categories then.

*(Note: New SEBI circular (dated Sep 2020) has mandated Multi Cap funds to invest 25% each in large, mid, and small. Funds have implemented it since Jan 2021. For majority of period under this analysis, Multi Cap funds have had flexibility to invest in any market space.)*



Similar trends of declining outperformance can be observed in ELSS and Multi Cap funds as well. It seems active funds across categories have failed to beat indices (and hence passive funds).

### Consistency of outperformance

There are funds that have outperformed even when most fund managers are finding it difficult to outperform.

But then another the question arises. How consistently the fund managers in the green zone outperformed?

And do the funds in green area consistently remain in the green area or we witness churn within?

To answer these questions, we calculate 'Consistency Ratio' of each fund.

Consistency Ratio is proportion of times fund has outperformed benchmark by at least 2% (*these are active funds. An investor may need at least 2% to compensate for taking active management risk*).

A fund that has 50% Consistency Ratio over 5 years (or 60 months) means fund has outperformed its benchmark by 2% or more in 30 out of 60 3-years periods. Higher the Consistency Ratio, more consistent the fund in terms of its outperformance. Summary of results is as follows:

Consistency	# Funds		
	Large	ELSS	Multi
Less Than 20%	8	8	7
20% to 40%	10	7	9
40% to 60%	6	13	8
60% to 80%	2	3	4
More Than 80%	-	1	1
<b>Total</b>	<b>26</b>	<b>32</b>	<b>29</b>

Most of the funds across categories have Consistency Ratio of less than 60%. However, there are few funds that have been consistent enough to have Consistency Ratio of more than 80%.

### To summarise

Even on rolling returns basis (which is a superior analytical tool than point-to-point returns), we have observed the trend of active funds finding it difficult to generate alpha since 2017. Under such conditions, does relevance for passive funds increases?

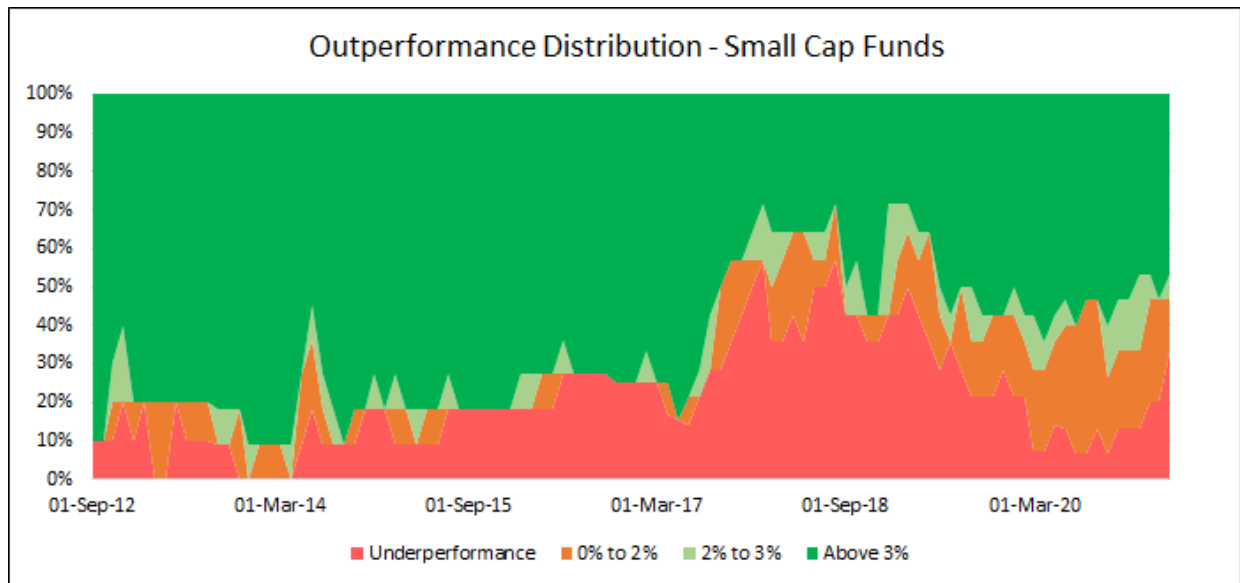
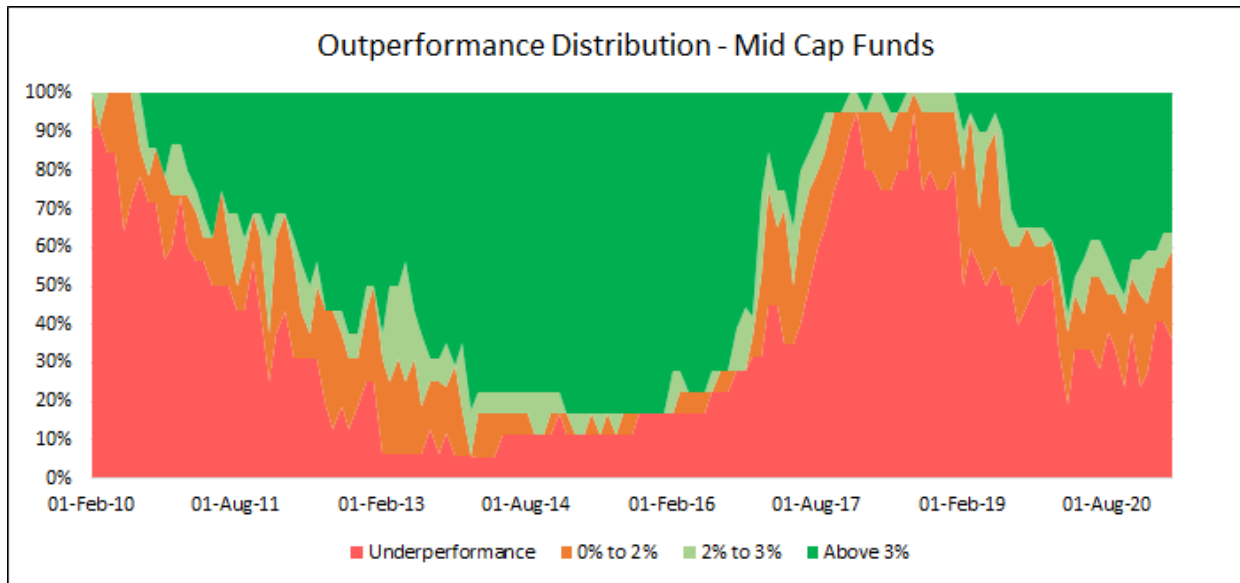
There are handful funds though that have managed to consistently beat indices. In such environment, role of financial advisors becomes even more crucial to identify funds that has higher probability to outperform under broader market conditions – not just based on past performance but also by diving into their portfolio's Quality, Valuation and Earnings and Technical Momentum.

Rational investing, Happy Investing!

### Annexure:

1. Assumptions or Limitations of the study:
  - a. Benchmark of the fund is assumed to be same as the current one since launch.
  - b. Fund is assumed to be part of a particular category since launch.
  - c. First outperformance for the category is calculated in the month where there are at least 10 funds.
  - d. Survivorship bias.

2. Mid and Small Cap Funds:



Interestingly, mid and small cap funds are still managing to generate excess returns. Mid cap funds underperformed during 2017 to 2019 but have started outperforming again in recent periods.

**Statutory Details: -**

**Multi-Act Trade and Investments Private Limited**

*(SEBI Registered Investment Adviser - Registration No. INA000008589)*

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