Assessing the effectiveness of **mutual fund categories** in Indian portfolios

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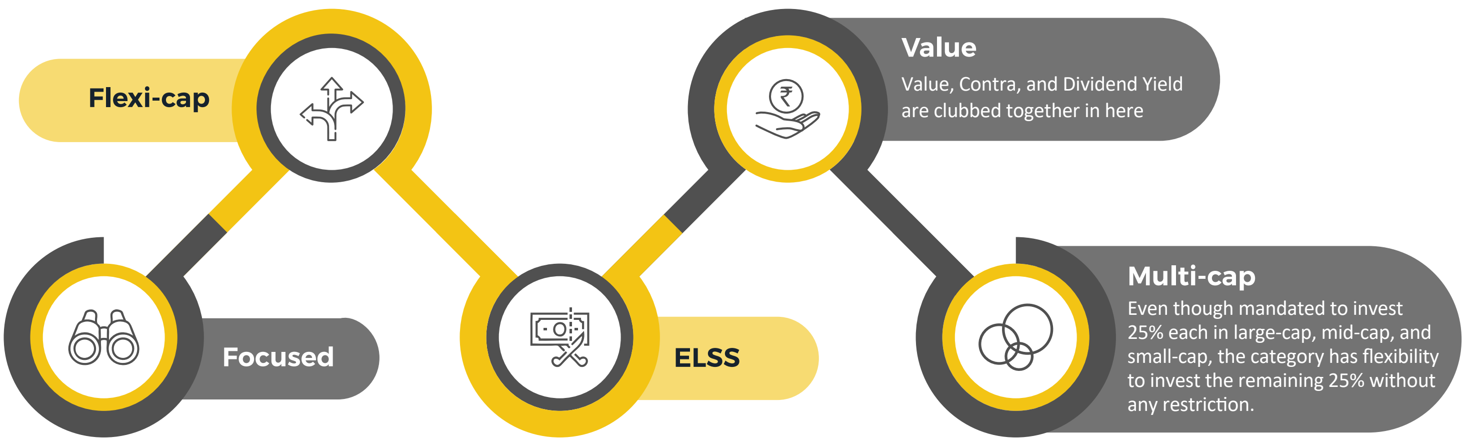
The investment landscape in India has now become increasingly dynamic and innovative with investors developing myriad and more nuanced needs. To optimally cater to these, we are correspondingly witnessing robust product-side innovation. In the backdrop of this landscape, we are seeing mutual funds emerge as a preferred investment vehicle due to multiple reasons ranging from ease of investment to the availability of a wide variety of funds that focus on different asset classes, sectors, market capitalisations, and themes. Within this, there are several mutual fund categories that are not mandated to invest predetermined amounts either based on stock market cap or sector. The main aim of these funds is to leverage market opportunities across the spectrum of investable ideas. The MF categories with such flexibility include:



Multi-Act has conducted an in-depth study to understand whether each of the above listed categories behave differently from each other in terms of returns profile, risk, and portfolio allocation calls. A total of 144 schemes (AUM above INR 100 cr as on October, 2023) were considered with a focus on the last 5-year performance history (since the SEBI recategorisation exercise).

Point-to-point return analysis

Over the last 5 years, each of the categories differed in terms of returns, drawdowns, the Sharpe ratio, and overall allocations across market caps. Allocation and performance across key metrics revealed some interesting takeaways:

1 Market cap allocation

- On an average, across different categories, the allocation to large-cap stocks is ~65%, mid-cap stocks is ~15%, and small-cap stocks is ~10%.
- The only outlier is multi-cap with an allocation of ~50%, ~24%, and ~21% to large-cap, mid-cap, and small-cap stocks, respectively. Further, compared to the broader market, allocations are less skewed towards large-caps.

2 Returns

- From a 5-year perspective, only the multi-cap and the value funds have outperformed the **broader market** with highest returns in the timeframe.
- On a 1, 3, and 5-year basis, the value and multi-cap funds have ranked in the 1st two positions (in terms of returns) when **compared to the other categories** like Focused, ELSS, and Flexi.

3 Maximum drawdown

- On 1 and 3 years basis, **value funds** have witnessed the lowest drawdowns when compared to the broader market and also vis-à-vis other categories. However, on a 5-year basis, **value funds** have witnessed the sharpest drawdowns relative to the other categories.
- In case of the **multi-cap category**, while the 1 and 5 year drawdowns are better relative to the broader market, the 3-year drawdown has been the highest across categories.

4 Sharpe ratio

From a risk-adjusted returns perspective, as measured by the Sharpe ratio, both the multi-cap and value categories have performed well across timeframes, outperforming the broader market in a majority of the cases and ranking in the 1st two positions when compared to the other categories being reviewed.

Exhibit: Average point-to-point returns as on October 2023

Category	Returns			Maximum Drawdowns			Sharpe			Average Allocation (5 Years)		
	1Y	3Y	5Y	1Y	3Y	5Y	1Y	3Y	5Y	Large	Mid	Small
Flexi	11.7%	21.1%	15.0%	-9.8%	-20.0%	-36.0%	0.43	0.99	0.52	66.0%	17.2%	10.3%
Focused	8.9%	20.3%	14.4%	-10.0%	-19.3%	-36.1%	0.18	0.93	0.48	72.2%	14.7%	7.7%
Value	17.1%	27.2%	16.0%	-8.0%	-17.1%	-38.6%	0.92	1.39	0.56	59.9%	17.5%	15.0%
ELSS	10.8%	21.7%	14.7%	-9.5%	-19.0%	-36.9%	0.36	1.05	0.49	66.6%	18.6%	10.7%
Multi	15.3%	26.9%	17.6%	-9.8%	-20.4%	-37.3%	0.74	1.28	0.62	49.7%	23.9%	20.9%
Nifty 500 Multi 50:25:25	15.6%	26.3%	17.1%	-11.3%	-19.8%	-39.0%	0.71	1.27	0.58	50.0%	25.0%	25.0%
Nifty 500	9.9%	21.9%	15.2%	-11.1%	-17.8%	-38.1%	0.25	1.03	0.51	78.8%	14.2%	6.9%

Overall, the average point-to-point returns indicate that from a returns perspective as well as from the perspective of risk-adjusted performance (as measured by the Sharpe ratio), both value and multi-cap funds score over the other categories and tend to have a more diversified exposure. This is particularly true in the case of multi-cap funds. Thus, for the next set of analysis, we have focused on the two strong categories, i.e., value and multi-cap and selected one consistently underperforming category, i.e., focused.

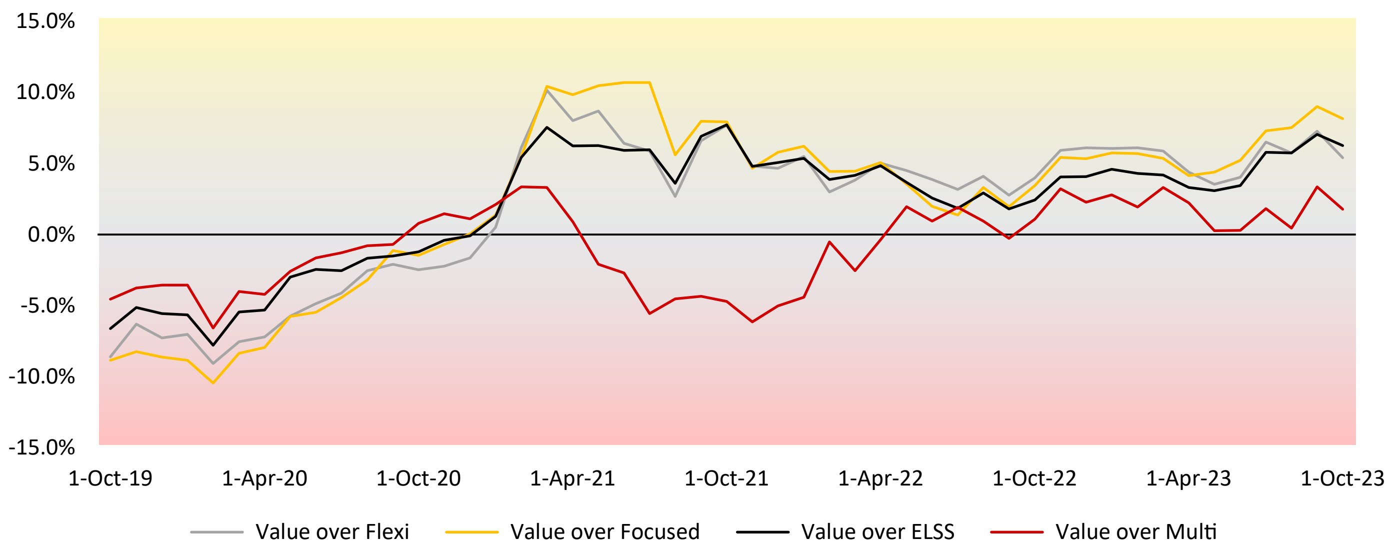
Rolling 1-year relative performance

Performing a deeper analysis, we evaluated how the value, focused, and multi-cap categories performed relative to each other and against flexi and ELSS funds. For the purpose of this analysis, outperformance on a 1-year rolling return basis was assessed. It was observed that:

The value and multi category funds have shown decent outperformance consistency against other categories of funds

There was a period till about March 2020 when 'Focused' funds fared better than other categories. However, this outperformance was not observed in recent times.

Outperformance on 1Y Rolling Basis - Value

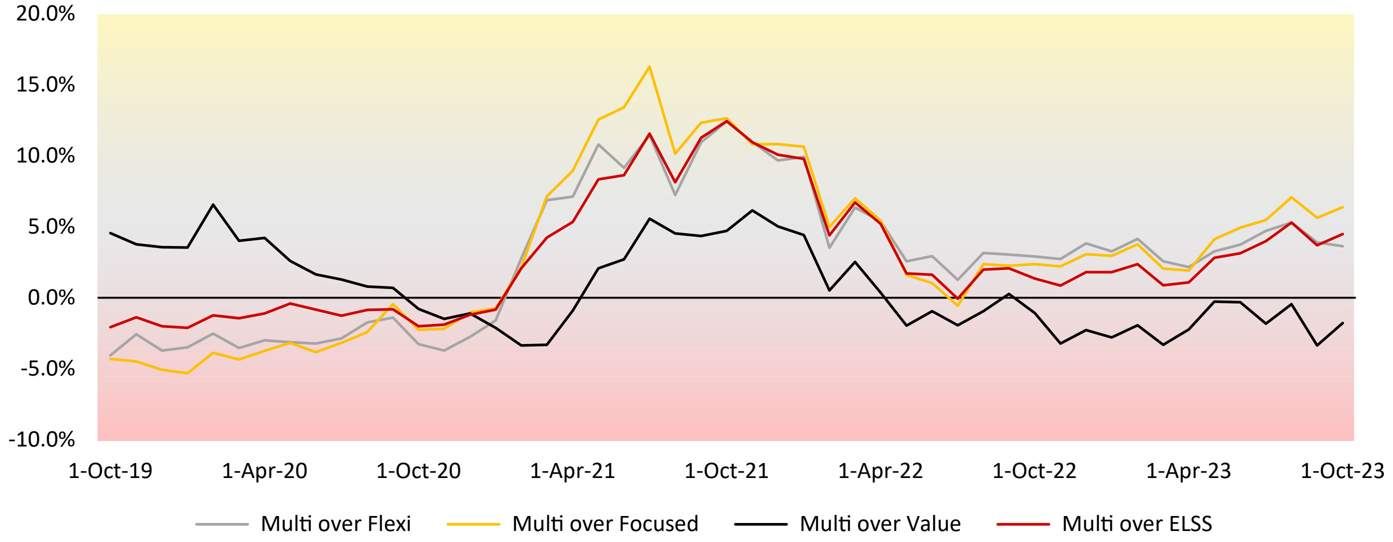


How to read the chart?

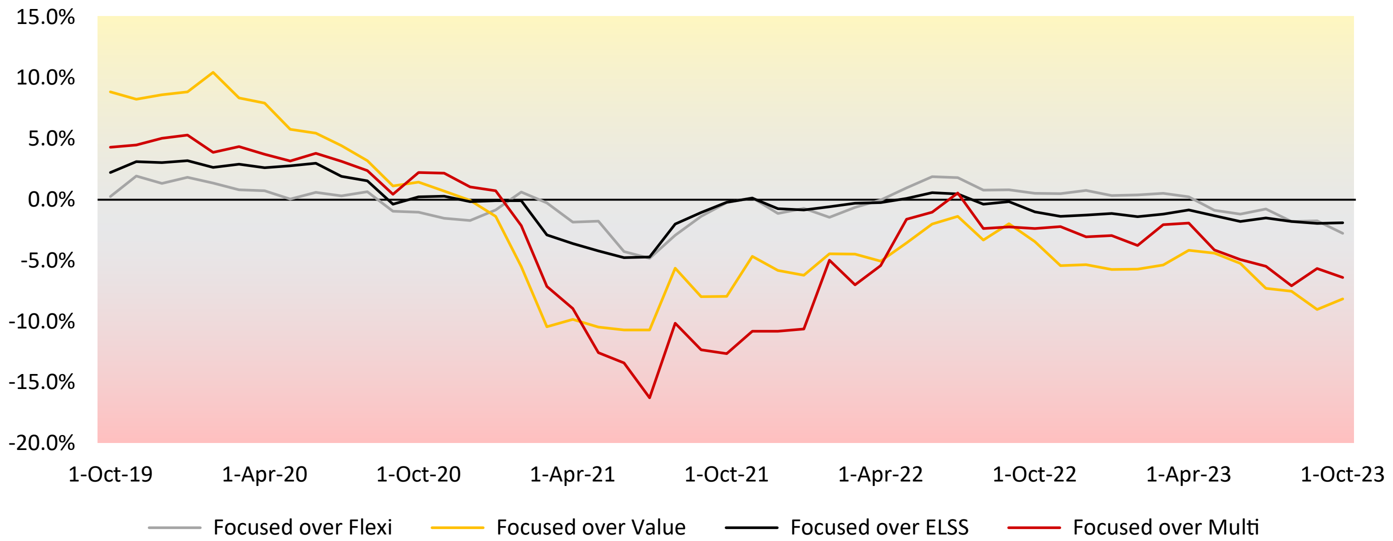
The rolling return of category A is compared to the rolling return category of category B to determine which category has generated the higher rolling return. The diference between these two categories is plotted in these charts.

For instance, in the above chart, we have compared the 1-year rolling return of the value category with the flexi, focused, ELSS, and multi-cap categories. The line in the red zone indicates that the value category has underperformed while the yellow and grey regions indicate out-performance and at-par performance, respectively. Accordingly, it can be construed that the value category has outperformed its peers for a majority of the time, with the multi-cap category (red line in chart) being an exception.

Outperformance on 1Y Rolling Basis - Multi

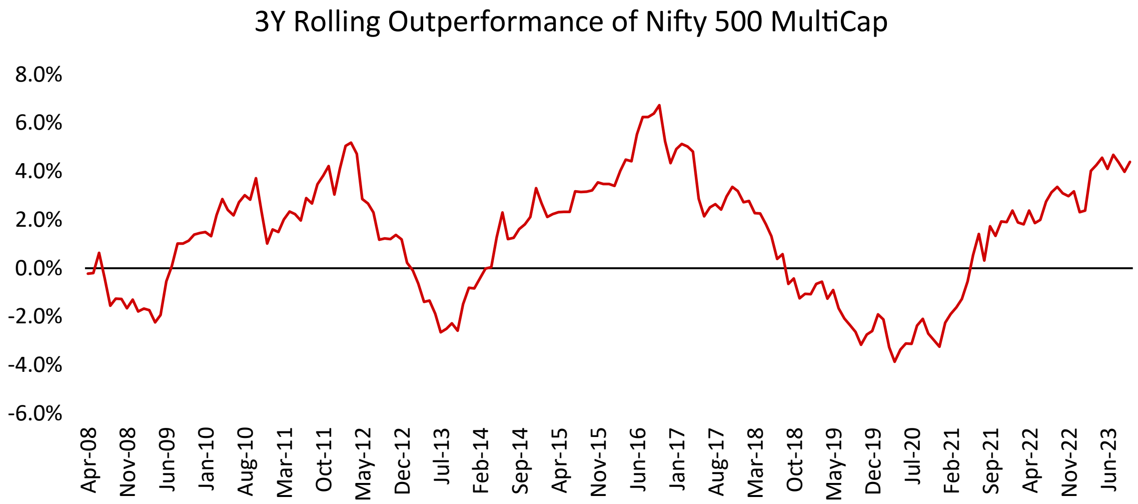


Outperformance on 1Y Rolling Basis - Focused



Multi-cap emerging as a compelling option

To test the efficacy of a diversified multi-cap fund portfolio on a long term basis, comparison was done with a constant allocation index (viz. Nifty 500 Multicap 50:25:25) with constant exposure to large-caps, mid-caps, and small-caps in the 50:25:25 proportion (this is similar to the current multi-cap category) to evaluate outperformance against the broader market, i.e., Nifty 500. Our analysis suggests that constant allocation to different market caps at predetermined levels has generally fared better than the broader market (2/3rd of the time), albeit with bouts of underperformance.



Outperformance Range	% of Times
-5% to -2.5%	8%
-2.5% to 0%	25%
0% to 2.5%	34%
2.5% to 5%	28%
5% to 7.5%	5%

Outperformance	
Average	1.3%
Median	1.8%
Max	6.7%
Min	-3.9%

In conclusion, across the observed metrics, i.e., returns, drawdowns, Sharpe ratio, and relative performance on a 1-year rolling basis, the multi-cap category has consistently delivered better risk adjusted return than comparable indices. Further, the multi-cap funds are also better diversified with larger allocations to mid-and-small-cap stocks compared to the flexi, focused, value, and ELSS funds. While the select categories have the flexibility to allocate across market capitalisations, they exhibit a clear skew towards large-cap stocks. From that perspective, the multi-cap category stands as an anomaly as, on average, its allocation across market caps has been more diversified, relative to the other categories. Therefore, given the relatively uncorrelated nature of the multi-cap category, its incorporation can introduce a unique dimension to the investment portfolio.

Disclosure and Disclaimer

Statutory Details: Multi-Act Trade and Investments Private Limited ("MATI") (SEBI Registered Investment Adviser – Registration No. INA000008589)

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