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Wed, Jan 13 2016. 02 43 AM IST

Don’t mimic mutual fund stock holdings

Investing in stocks just because some funds have invested in them is not a sound way of participating in equity

Kavya Balaji

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Mutual funds (MFs) are run by fund managers with significant expertise and whose job it is to ensure that the fund beats the benchmark in the long run. Therefore, it might seem profitable to simply replicate a fund’s portfolio. But that’s not a great idea because in doing so, you are essentially trying to guess what a fund manager is thinking, which is an impossible task. There are other reasons too.

Funds’ objectives

Every scheme is launched with a particular objective. For instance, large-cap equity funds invest mostly in large-cap stocks. “Every MF has schemes that invest money based on their (respective) investment objectives and strategies. These objectives may not be in sync with the retail investors’ strategy,” said Vaibhav Agrawal, vice-president and head-research, Angel Broking Pvt. Ltd. A fund manager may exit the stock in a year or two while your goals might indicate you need to remain invested for five or more years.

Another point to note is that MFs do not always ‘pick’ stocks. “MFs are bound to have large holdings in most large-caps because they often go overweight and underweight relative to benchmarks, like Nifty or BSE200, on which they are judged,” said Vikas Gupta, executive vice-president and chief investment officer, Arthveda Fund Management Pvt. Ltd. Just because MFs hold large amounts in a particular stock doesn’t make it a great pick.

Matter of performance

All stocks that MFs choose will not be winners. Mint took the top 10 stocks (in terms of value) that funds have invested in and found that six out of 10 stocks underperformed their sector indices in the long term. For example, State Bank of India (SBI) has returned a negative 4% per annum in the past 5 years while the BSE Bankex has risen by 7.76% per annum in the same period. Larsen & Toubro Ltd is another example. “Delay in economic growth and subdued order inflow has reflected negatively. Year-to-date, L&T has given negative return of 14.3%,” said Vinod Nair, head, fundamental research, Geojit BNP Paribas Financial Services Ltd. In a 5-year period, L&T has returned negative 0.46%.

Among the top 100 stocks in which MFs invested, four out of every 10 stocks underperformed in the past 10 years. Vedanta Ltd is one such example. The stock has given negative returns of 24% per annum for the past five years and 146 schemes have holdings worth `957 crore in it. Funds may have entered the stock at lows and exited, and re-entered at lows.

Even top stocks, in which MFs have invested, might not be great picks. ITC Ltd has returned a negative 16.49% per annum in the past 10 years. Yet, 384 schemes hold its shares worth `6,140 crore.

“Many banking stocks, such as ICICI Bank, Union Bank, Bank of Baroda and Federal Bank, that have MF ownership of more than 5% have lost more than 25% in value over the past one year,” said Agrawal. Despite such investments, according to data by Value Research, the top 100 MFs have returned an average of 15.7% per annum for the past five years. This is because fund managers use their expertise to decide entry and exit from stocks at different points in time.

Holdings and volatility

Large amounts invested in stocks by an institution means its every move would have a significant impact on the stock. “In case of an adverse event in an industry, institutional investors may start exiting, and the very reason the investor entered into the stock could backfire. The stock may correct significantly because it had a high institutional holding,” said Agrawal.

Also, when institutions such as MFs start selling a stock, prices can tumble quickly. “If they sell in large numbers, the downfall is much bigger in the near term,” said Gupta.

“Retail investors come to know about such moves post-disclosure by MFs at a later date,” said Gaurav Jain, director, Hem Securities Ltd.

Another point to note is that among the top 50 holdings by MFs, 60% have beta of more than 1. Beta measures the movement of the stock in relation to the movements in the market. A value higher than 1 indicates that the stock would be more volatile than the market. So, this indicates that most stocks held by MFs are volatile in nature.

Value buy

When picking a stock, investors check if it's a value buy, and the price-to-earnings (P-E) ratio is used as an indicator of this. "A thumb rule one could use is to stay away from companies at P-E ratio greater than 25," said Gupta. Going by this, among the top 50 stocks chosen by MFs, 40% have P-E higher than 25. "If most MFs have already bought a stock, it is likely to be fairly valued or overvalued," said Gupta. Essentially, what is value today may not be so after two years. Or, it may not be a value buy for you even if it is for a fund manager.

MFs time markets and enter stocks at certain price points, which is not possible for a retail investor to do.

Threat of over-exposure

MFs often invest in popular sectors. Of the top 10 stocks favoured by MFs, five belonged to banking. For retail investors it is important to invest across sectors as a particular sector can underperform in the long run. For instance, banking stocks have underperformed FMCG and pharma in the past 5 years.

Even if you were to choose stocks from among the top 50 that MFs have invested in, you may end up being overexposed to some sectors. Out of the top 50 stocks preferred by funds, 20% are in financial services.

"It's important to identify sectors that will be the performers during the medium- to long-term, for example, by dividing into growth, defensive and cyclical," said Nair. Fund managers invest based on strategies and themes that are best suited for the fund house, and which may not be right for small investors.

Choosing the right stocks

You must be convinced of a company's business and earning potential. "Analyse the growth prospect for the next 2-4 years; study its business monopoly and demand for its products; and be convinced that the company has high growth potential, strong management and low- to mid-level of valuation," said Yogesh Mehta, vice-president, equity advisory, Motilal Oswal Secrities. Low debt levels are equally important.

If you are not comfortable taking decisions on your own, consider expert advice. "Experts have access to more information through (company's) management meets, which is not possible for retail investors," said Jain. But don't leave everything to experts.

"Take the advice as guidance and ensure that it is in line with your objectives. It is wise to be convinced of the rationale on which the recommendation is made," said Nair, adding that stocks favoured by MFs can be used as a screening criterion.

The reasons for which funds choose a stock may be different from a retail investor's needs. So, following on their footsteps is not the best way to select stocks.