Mirae Asset Knowledge Academy

Profit from Knowledge

Consistency & Quality of Investment

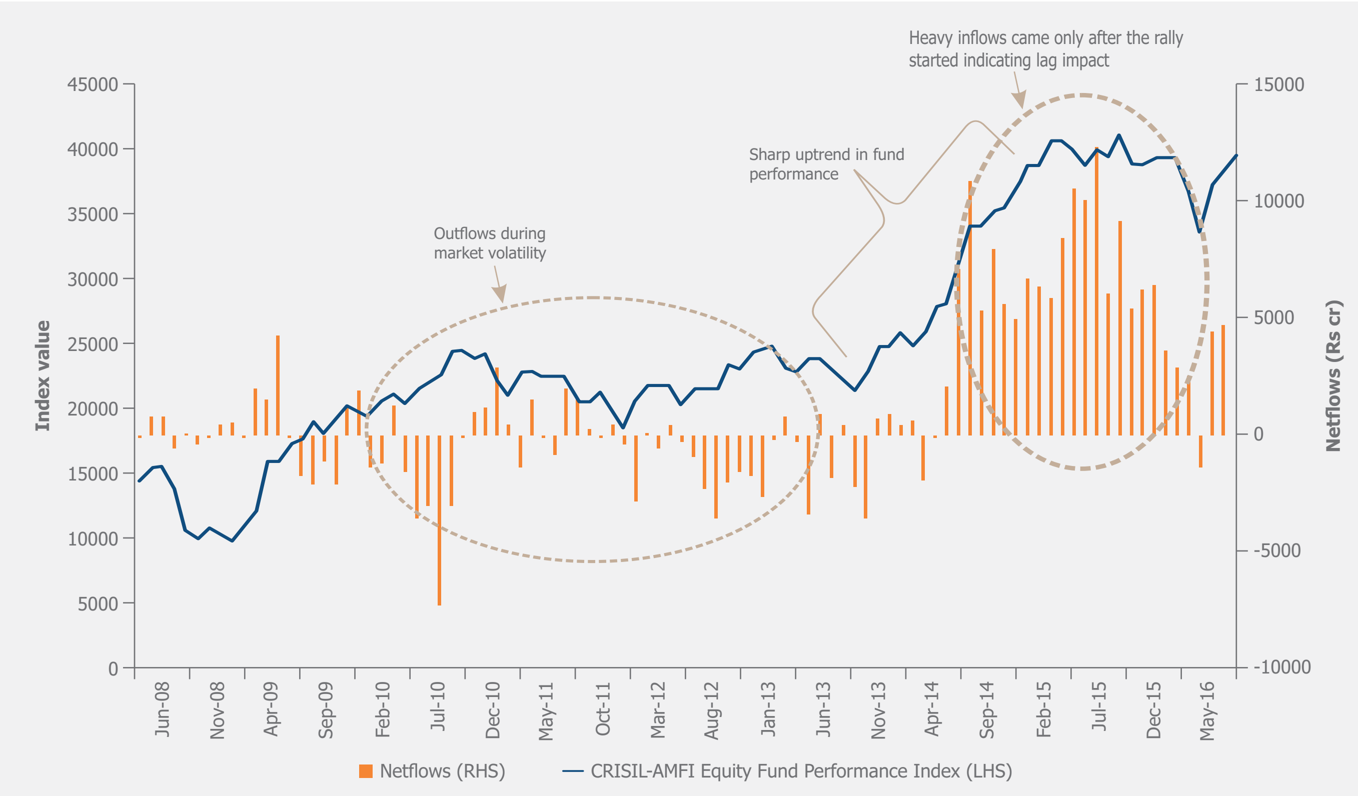
A primer for financial success

Ever wonder what makes successful investors stand out in a crowd? It is their rock solid temperament, the ability to take rational decisions in euphoric and pessimistic times, and a deep conviction to stick to quality investments through the market cycle. This article throws light on how investors' behaviour and notions impact their investments and why one should look for consistency in investments over the long term.

Timing the Market is futile

Buy low and sell high is the basic thumb rule for all investors. But, in practice, it is hardly followed as behavioural biases and notions overrule. Emotions such as fear and greed, and notions such as making smart money by timing the market results in making investment decisions with a lag (chart 1). And, the resultant avertable churning of portfolio can negatively impact returns in the long term.

Chart 1: Market movement^ versus investor inflow / outflow trend



^Represented by CRISIL-AMFI Equity Fund Performance Index
Source: CRISIL Research, AMFI

Let's take a look at a case study to better understand the science of investment.

Case study: Drawback of timing the market

Strategy		Returns (%)
A - Timing the market	Investor decided to churn his investments by buying & selling as per market movement	5.72%
B - Investing regularly	Investor regularly invested via SIP	14.40%

Note - Strategy A is based as per the inflow / outflow trend seen in Chart 1.
Last eight-year data is considered, beginning June 2008 until May 2016.

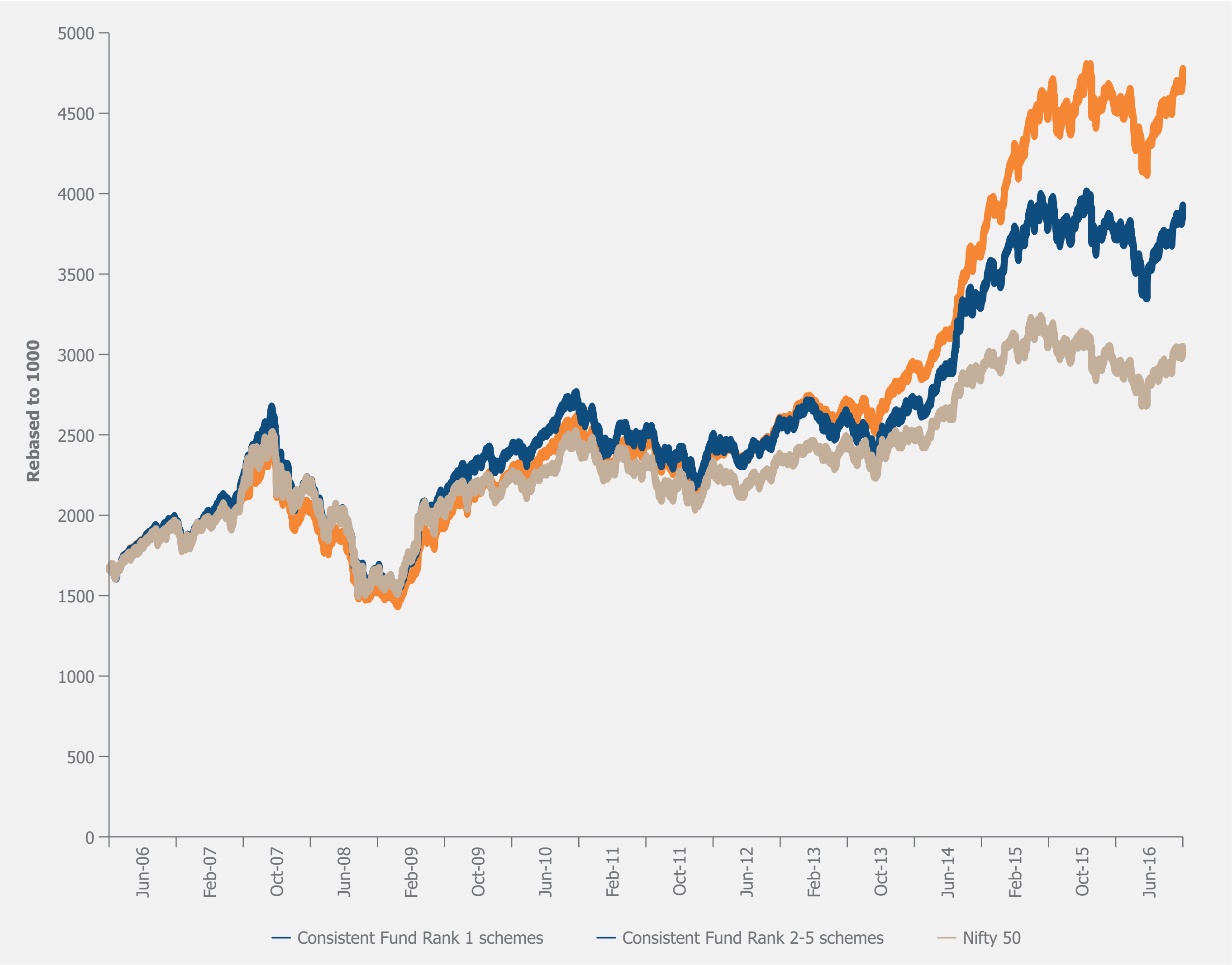
While trying to time the market (Strategy A), a lagged impact resulted in investor removing money when fund performance was lower/ volatile and investing more after fund started performing well (refer chart 1). Because of poor timing, Strategy A fared poorly with annualised returns of 5.72%, lower than 14.40% earned via Strategy B.

Quality of investment matters

Along with consistency, quality of investment - choosing the right fund – is important. Some funds can give extraordinarily high returns when markets are up, but lose money when they are down. Investors should be very cautious while selecting a fund based on analysis of the recent short-term performance of the fund.

For instance, a fund which grows 14% annually for five years is better than the fund which grows at a whopping 35% CAGR annually in the first three years and falls 15% p.a. in the next two years, giving net annualised returns of 12% in five years. Investors should look for consistency in fund performance over the long term. Top ranked consistent funds (chart 2) have not only outperformed the market benchmark (Nifty 50) but also outdone peers over 10 years.

Chart 2: Performance of top ranked funds versus category & market benchmark



Consistent ranked funds as per CRISIL Mutual Fund Ranking March 2016 used for analysis Peers represented by consistent fund rank 2-5

Examples of successful investment managers

The fund managed by Mr. Peter Lynch averaged 29.2% annual returns (1977-1990), more than double the returns provided by S&P 500 index, making it one of the best performing mutual funds till date.

Another great example of consistency is of Mr. Warren Buffet's investment holding company Berkshire Hathway. The company's share price returned 20.8% between 1965 and 2015 compared with 9.7% returned by S&P 500.

These example highlight how fund outperformance can continue for long time periods, inspite of strong surge in AUM.

How to find quality mutual funds

To find high quality funds, investors should look for relative performance - how it has performed vis-à-vis peers and the benchmark across various time frames.

1. Relative performance

For relative performance comparison, investors can look at the fund's quartile ranking as it will show how the fund has performed vis-à-vis peers in the time frame considered. Investors should also look at how the fund has performed vis-à-vis peers and the benchmark in both bull and bear phases.

2. Risk and portfolio traits

The risk element involved in a fund often gets sidelined in the peak period, and its true nature is only exposed in the trough of an investment cycle. Hence, due importance should be given to risk-adjusted returns and portfolio attributes such as diversification, stock and sector exposure, asset allocation and liquidity.

3. Fund management

A look at the fund manager's track record will give insights about his/ her expertise in managing fund portfolios. Quality funds are backed by efficient fund management and robust investment processes and risk management practices. This helps them focus on superior risk-adjusted returns in the long term and, hence, investors should not worry much about the short-term blips.

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