

## Exercising options

# How to select a good equity mutual fund?

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Selecting a mutual fund for investing is a very important step indeed. It is not just important it is crucial. However, it is the second step, not the first.

It is surprising at the number of people I meet or hear from they all have the same questions. So when they ask me 'How do we select a mutual fund?', it amuses me. Like all self respecting advisors, I start with the dreaded line - "Well, it depends! .."

Then I ask them - "What are your financial goals, if any?". Now only if you have big long-term goals, then actually the choice of a mutual fund really matter. If you are investing for a short period of time, you are investing in say a liquid fund, it hardly matters in which liquid fund you invest - the performance gap between two liquid funds is not so high. Choose the liquid fund with a high AUM (assets under management) and one which gives good service in terms of redemption on the phone or internet, or such considerations.

However, if you are looking for an investment for longer time which means you are looking to be invested for at least 8 to 10 years, you should invest in equity mutual funds. This article is aimed at selecting a good equity mutual fund for a long term.

- The most important first step is to have an investment goal. A fantastic fund selection done without having an investment goal is completely useless. You should know the reason for your investment, how long you can be in the investment, at what stage you will re-allocate, etc. before you make your first investment.
- Your focus will lead to the correct

asset allocation - the very important factor which will decide how much money you will put into an equity fund.

- Do your homework: Buy large cap well diversified good quality funds, international funds, contra funds as a staple part of your portfolio.
- All funds in India are no load funds - which means there is no sales cost. This is good and it means all your money gets invested. For a large cap equity fund, it may not make too much sense to pay somebody to pick the fund for you, try doing it yourself.
- Have a demonic watch on the asset management charges. As a fund starts to do well, it should attract a lot of investors, and as its assets increase it should keep dropping its asset management charges. Look at well managed funds with charges below 1.9% p.a. - there are many.
- Look at the portfolio turnover ratio - the greater the ratio, the more is your total cost. One cost which is not visible to the investor is the brokerage that the fund scheme pays. This is a function of the turnover of the portfolio. So a fund with a lower turnover would be incurring lesser costs.
- The asset management company's team is important too! Look for experienced teams where the managers have gone through a few business cycles. Managers who have not seen a down market can be very myopic, and those managers who have been through a prolonged slow down through a pessimistic. You need a nice blend in the team.
- True to label: When you buy a large cap fund, you are buying a large cap fund, simple. If a fund says it is a large cap fund, it should not be buying mid cap, small cap etc. just because large caps are currently out of favor. It is your choice to be in a large cap fund and your fund manager should respect it.
- Philosophy matching: Some fund houses are cooler and calmer compared to others. See which philosophy suits you. For example Templeton says Franklin India blue chip is a 'growth' oriented, large cap fund, whereas Templeton India Growth fund is a 'value' oriented fund - see what suits you. HDFC mutual fund on the other hand does not classify itself into 'growth' or 'value' labels.
- Fund management is by a team or a star fund manager: Fund management is part science and part art. The fund manager will surely leave a stamp. However, some fund houses have been able to create teams and systems to handle the departure of fund managers - this gives you greater peace of mind. A star fund manager could leave or even worse just drop dead - and you keep wondering 'now what!' Internationally and in the Indian context, well performing funds (over say 10 years) have seen very stable management teams and CIOs.
- Over extremely large periods of time, it is really difficult to beat a well managed index fund. Currently all fund houses show schemes beating the index, but beware of mathematics! All fund houses put a small \* and say calculation does not include loads. Do a small calculation if loads are



included. Just too many schemes would have under performed the indices. So if you are not looking for too much excitement, look for an index fund with fund charges south of 1% per annum.

- Index funds with the Sensex as a benchmark are at least theoretically supposed to be more aggressive than an index fund with Nifty as the benchmark. Frankly it does not matter - if in doubt, split your investment amount. The correlation between Nifty and Sensex is quite high.
- When selecting a large cap equity fund, choose those with as broad a benchmark as possible. It is better to choose a fund with CNX 500 as a benchmark rather than the Sensex. Fund managers may have a greater flexibility between large

caps, small caps, etc.

- Do not chase performance. The fund which has performed well in one quarter may not perform well in the next quarter. Funds with a good long term top quartile performance are far superior than a fund scheme which has one top position and one bottom position. Remember long term investing is like running a marathon - stamina is more important than speed.
- At the top in the well run large cap funds are HDFC top 200, DSP top 100, Principal Large cap fund, Franklin India blue chip, and HDFC Equity fund come to attention. This list is not exhaustive and many fund distributors and banks have their own favorites. This list passes the test prescribed above - of good consistent returns, good

long term performance, team going through a bull phase and a bear phase, true to label, etc. Importantly as the fund size has increased, these schemes have reduced the asset management charges and thus improved the total return to the investor.

- Invest only by the SIP mode, especially if you are investing for a period of say 5 years. If your investment horizon is upwards of 7 years, even a lump sum would do - but seeing ones portfolio hurts! The most important thing, like John Templeton said 'Start with a prayer, it helps!'.

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