

## Why Mutual Funds will disappoint?

Last 5 years have been rewarding for people having holdings in mutual funds. An average diversified equity mutual fund has yielded a compounded return of almost 43 % (as of 30<sup>th</sup> May, 2008) in this period. That means that Rs 100 invested in an average performing mutual fund has yielded almost Rs 600 in this period. Also because the rise in prices have moderate for most of this period the real returns have been almost as attractive. However, times have changed. At current level for stock market buying into a mutual fund investing in large companies (a category in which more than 95 % of equity mutual funds belong) is likely to be disappointing. By this we mean that there is a small probability (less than 20 per cent) that returns would equal or exceed 10-15 per cent and a large probability (more than 70 per cent) that returns will be less than 5 per cent in next two years. Negative real returns are a real possibility for mutual fund holders. We present the logic for our conclusion below.

The first reason we are negative about all the mutual funds that invest in large companies is because the holdings of large mutual funds are similar and these holdings are expensive. Despite the correction in stock market since January, the valuations of shares of large companies remain high. The price earnings ratio of Nifty is still in excess of 20, while dividend yield is close to 1 %. Holders of shares of large companies are getting 1 rupee as dividend for every 100 rupee invested currently. When prices of shares were rising this seemed alright. Now that the prices are not rising these low dividends would be difficult to ignore. Even if the dividends rise by 20 per cent the prices of shares of large companies need to fall by more than 10 per cent so that the dividend yield comes close to 2 %. A 2 % per cent divided yield is when these would begin to look attractive to some new buyers. Historically even 2 % would be considered low. So there is a probability that these shares and therefore most mutual funds would fall more than 10 per cent.

The reason for the rapid increase in share prices in recent times has been because the real growth of companies' profits exceeded the expected growth. This was a situation when GDP growth increasing at a ever faster pace. Now exactly opposite is more likely to happen. Inflation is high and rising, while oil and fertilizer subsidies are ballooning. High inflation means high interest rate which lead to slower GDP growth. Higher subsidy bill means more taxation. Overall growth in profitability of large companies will be much slower. So, high expectations are unlikely to be fulfilled. This would lead to further correction in share prices. Since mutual funds hold more than 90 per cent of their assets as shares of these companies, they are bound to be affected.

A major reason for Indian market to go up was inflows from FIIs. India had been one of the must own places for these investors. Now these investors are pulling money out of India. There has been growth in risk aversion among these institutions. With credit losses hitting almost 400 billion USD, institutions want to park there capital at places they consider safe. India with high fiscal and trade deficit is not very high on the list of safe places. Among the emerging markets India continues to be the most expensive major market that is open to FIIs. India is still more than 30 per cent expensive than average of emerging markets. In this situation FIIs are unlikely to turn buyers. At best we can hope that they do not continue to sell.

**Rational Investment Research Pvt. Ltd.**  
**7-A Birat Complex Boring Road Patna 800013**

**Website: [www.rirlimited.com](http://www.rirlimited.com)**

**June 2, 2008**

So what should holders of mutual funds do in this scenario? Selling some of the holdings would be good idea. Also, at this point of time one has huge opportunities in small cap companies. These companies are quite cheap and pay substantial dividends. One can look for buying mutual funds specialising in just small cap stocks at this point of time. However, one should be ready to accept temporary losses as these small cap stocks could fall somewhat more when market falls. In 3 year period starting now, mutual funds specialising in small cap would deliver decent returns.

“Uncertainty is not a pleasant state of mind but certainty is absurd” – Voltaire