Benchmark Gun to the MF Head

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Professional investors with relative return mandates often get tormented by the benchmark indices they are expected to beat. We find active fund managers struggling to even match the performance of their respective benchmarks. This phenomenon is more pronounced in large-cap and large cap-oriented fund categories. Why does this happen?

Benchmark indices for the large-cap mutual fund category are typically dominated by a few heavyweight stocks. This is quite evident from the composition of NSE100, a popular benchmark for large-cap mutual fund schemes. Top 5% of constituent stocks account for more than a third of the total benchmark weight, while top 10% of constituent stocks account for almost half. At the lower end, bottom 25% constituent stocks account for just 4.5%, while bottom 50% account for just over 13% of total benchmark weight.

This top-heavy nature of the benchmark creates a major dilemma in the minds of fund managers of large-cap mandates. Should they own, or not, big benchmark stocks where their level of conviction is low? For most readers, the answer is obvious: they shouldn't own the stocks where they have low conviction. However, from the perspective of professional fund managers, things are not so simple and easy.

Let's say they decide not to own big benchmark stocks where they have low conviction. But what if these stocks go on to materially outperform subsequently? That could result in significant underperformance of their funds compared to the benchmark. In a competitive market, this is not an easily palatable option.

This fear of underperformance often leads to fund managers taking underweight or neutral positions in these low-conviction heavyweight benchmark stocks. In a way, these fund managers are falling prey to the tyranny of their benchmarks.

This unfortunately leads to a lot of capital getting blocked in defensive bets. Analysis of October 2022 portfolios of all large-cap mutual funds reveal that, on an average, 48% of the schemes have a non-zero underweight position in top 10 stocks in the benchmark.

Guys, is a large cap too much to ask for?

In any case, due to the nature of the benchmark, even overweight positions in big benchmark stocks consume a lot of capital. So, only a small proportion of the capital is available to take active positive bets to generate alpha.

This suboptimal allocation, which is driven by the fear of underperformance, unfortunately leads to the same outcome that they seek to avoid. This phenomenon largely explains why an appallingly large proportion of large-cap mutual funds fail to beat their benchmarks.

An overwhelming majority of the large-cap mutual fund schemes have underperformed their benchmarks on a trailing-return basis over 1-, 3-, 5-, 7- and 10-year periods. Analysis of calendar-year returns, for the last 10 years, of these large-cap funds relative to their benchmarks shows that, collectively, they have not been able to generate outperformance.

On an average, 58% of the funds have underperformed their benchmarks in this period. 2018 was the worst year on record with 93% of funds underperforming, while 2014 was the best year with only 15% funds underperforming. However, Sebi issued guidelines for classification of stocks in large, mid and small categories and strict adherence to the mandate about five years ago. So, the superior performance of the large-cap funds in 2014 was perhaps due to high allocation to mid-cap and small-cap stocks, which massively outperformed large caps in that year.

Given the disappointing performance and structural constraints due to the top-heavy benchmark, investors seeking an exposure to the large-cap universe can consider owning index funds or exchange-traded funds instead of actively managed funds, thereby performing in line with the large-cap index. Alternately, consider genuinely benchmark-agnostic active strategies where investors may at least have a shot at generating alpha.

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