From the Fund Manager's Desk

"Index Investing: Best kept secret of Investing" – Dec 2020

The oracle of Omaha, Warren Buffett has long hailed index funds as the best investment alternative for all kinds of investors. The master investor even challenged the hedge fund industry back in 2008, contending that in the next decade, an S&P 500 index fund would outperform a basket of hedge funds after fees and expenses. He won the wager hands down, with cumulative index returns amounting to four times the return on the hedge funds basket.

Back home, the majority of Indian mutual fund investors have also had an unhappy experience lately, as most of the active mutual fund schemes have not been able to outperform a simple buy-and-hold-index strategy.

In the last 3-5 years, only 8 active large cap mutual funds have been able to outperform the average large cap index ETF's.

	3-year	5-year
Sensex / Nifty ETF Return*	11.99%	12.87%
Number of outperforming Large Cap Mutual Fund Schemes	8	8
Number of underperforming Large Cap Mutual Fund Schemes	165	124

Source: Valueresearchonline.com
*Return for the best performing Sensex / Nifty ETF

So, what's gone wrong? How come the highly-paid smartest managers on the street have not been able to keep up with the index? Let's find out.

The index is quite mechanical and passive in its approach with no mind of its own, while mutual funds are an active class of investment handled by fund managers who use their discretion and judgment to build portfolios.

Managers can go overweight or underweight individual stocks based on their conviction on the potential of stocks. However, this deviation from the index does not always turn out as expected.

The general tendency of going overweight underperformers because they appear "cheap" and going underweight outperformers because they appear "expensive" is the root cause for poor performance. The index is placed at the exact opposite end of this philosophy. The index automatically increases the weight of "winners" and decreases the weight of "losers", sometimes eliminating the underperformers to make way for new promising candidates.

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For example, Nifty50 today looks a lot different than what it used to look back in 2008. 50% of the Nifty50 stocks have changed during this time, making way for other promising newcomers. Stocks like Unitech, Suzlon, RCOM, and Satyam computer, which were a part of the Nifty50 back then have gone to near-zero levels!

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Nifty Laggards	Nifty Weightage (2008)	Nifty Weightage (2020)	Stock Performance
BHEL Ltd.	3.54%	0	-87%
DLF Ltd.	3.86%	0	-68%
Reliance Communications Ltd.	3.69%	0	-99%
SUZLON Ltd.	1.39%	0	-99%
NTPC Ltd.	5.69%	0.85%	-40%
Unitech Ltd.	1.57%	0	-99%

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Nifty Leaders	Nifty Weightage (2008)	Nifty Weightage (2020)	Stock Performance (From Date or post inclusion)
Reliance Industries Ltd.	11.56%	13.24%	243%
HDFC Ltd.	2.37%	6.87%	376%
HCL Technologies Ltd.	0.59%	1.82%	1260%
HDFC Bank Ltd.	1.66%	10.25%	944%
HUL	1.75%	3.69%	842%
INFOSYS Technologies Ltd.	2.89%	7.74%	528%
TCS Ltd.	2.78%	5.58%	1250%
ICICI Bank Ltd.	3.00%	5.40%	253%
Kotak Mahindra Bank (Included in 2011)	0.00%	4.52%	683%
Asian Paints (Included in 2012)	0.00%	1.99%	586%
Bajaj Finance Ltd. (Included in 2017)	0.00%	1.75%	165%
Nestle India (Included in 2019)	0.00%	1.22%	36%

One might argue that 12 years is quite a long time in the life of an index. In that case, here's a myth buster. Over a quarter of underperforming Nifty50 stocks have been dropped in the last 4 years and a fifth in the last 2 years, replaced by new winners. That's a significant change for the headline index in such a short horizon. The clever Nifty clinically cuts its losses and doubles down on its winners in a boring, passive manner. The index follows a system that is automatic with no room for biases. Individuals, including the star managers, always have biases.

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This brings us to a couple of pressing questions. Is outperforming the index a thing of the past? Should investors stick to index funds and shun active funds altogether?

Not necessarily.

There are several boutique managers (PMS / AIF's) that are specialized and whose styles are very unique. These boutiques neither try to beat the index day in and day out, nor do they chase AUM growth at the cost of investor returns. Just like the index follows a style of overweighting winners and eliminating losers, boutique managers follow differentiated strategies that could add value to investors and help grow their money.

We make a serious case for allocating a significant part of your capital to index funds. Underowned, unloved, misunderstood and definitely not marketed! There is a case for allocating bulk of your equity investments into index funds. These instruments are low on fees, unbiased, system driven, and have a better track record than most active fund managers in India! Shall we say any more?

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