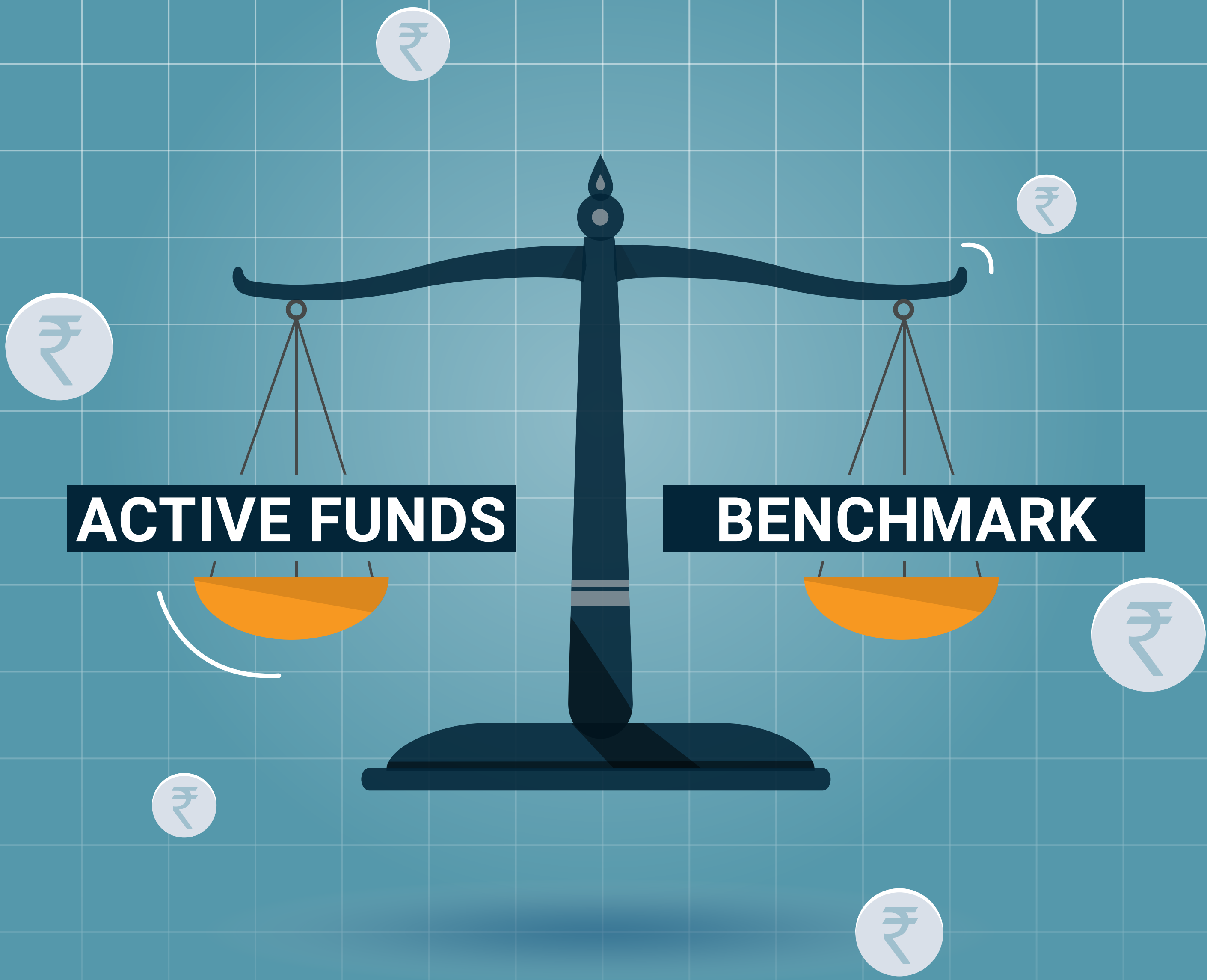

ARE ACTIVE FUNDS RELEVANT IN INDIAN MARKET?

One of the most heated debates in the investment world today is whether active funds outperform their benchmarks consistently enough to justify the fees they charge their investors.

The increasingly louder noise today would lead one to believe that active funds, on average, underperform their benchmarks and do not justify the fees they charge. We have analyzed the data and we have reasons to disagree. And in this note, we will try to demonstrate why.

Introduction

Before getting into details, here is a quick overview of what active funds are. Active funds take active risks. Active risk means:

1. owning stocks that are different than those in the benchmark and
2. owning stocks in a proportion that is different compared to the benchmark.

Because active funds attempt to beat the benchmarks, they have to take active risks. Of course, this can lead to better or worse performance compared to the benchmarks. While many people, especially in the Western markets, believe that it Is not possible for active funds to outperform their benchmarks, there are many who firmly believe in their ability to outperform.

Why the difference of opinion?

It is primarily due to people looking at only a small portion of the entire picture. Let's use an analogy to explain this.

1. Imagine that you are a quality inspector hired by Indian Railways.
2. You have to judge the punctuality of a train that has 250 stops along its scheduled route.
3. You board it from one of the stops along its route and alight at another stop.
4. The train is late by 30 minutes by the time it reaches this stop, and you conclude that the punctuality of the train service is poor.
5. However, you fail to appreciate the punctuality of the train from and to other stops, which may have been different.
6. After doing a detailed study from each of the different possible stops, you learn that on any given day, on an average, the train is late only on 50 of the 250 stops.
7. Moreover, on the day you boarded the train, there was a minor accident causing a delay along your route.
8. Hence, the train service may actually be much superior to what was earlier believed.

The difference in conclusion is due to analyzing only a fraction of the total outcomes; i.e., punctuality on one stop on a given day instead punctuality across 250 stops on any given day.

Coming back to active mutual funds' performance.

1. Out of more than 250 trading days in a typical year, most public studies look at the performance as on a single-date; say as on 31st December or 31st March.
2. Hence, they only analyze the outcomes for less than 0.4% of the total possible outcomes in any given year.
3. They also ignore the performance achieved across the timeframe.

For instance, a synopsis of this type of performance analysis is presented below. It tells us what percentage of schemes in a category outperformed the category benchmark as on 30th September 2021.

As on 30th September 2021	1 Year	3 Years	5 Years
Scheme Category	**% of schemes (Regular Plans) beating the TRI benchmark**		
All schemes	35.89%	41.34%	29.09%
Largecap	31.03%	32.14%	11.11%
Flexicap	32.00%	34.78%	25.00%
ELSS	36.84%	34.29%	21.88%
Large & Midcap	67.86%	59.09%	13.64%
Midcap	3.85%	60.87%	57.14%
Smallcap	34.78%	66.67%	92.86%
Focused	34.78%	35.29%	20.00%
Value	47.06%	12.50%	14.29%

 # TRI Benchmarks are taken into consideration

As can be seen in the table above, majority of the schemes have been unable to beat the benchmark over different time periods as on 30th September 2021.

Just like in the train example, this way of analysis is imperfect because of two reasons.

1. Because investors can invest on any day of the year, this "single-date" analysis does not explain how the funds have performed throughout the previous years;

2. Secondly, on the particular date that is chosen, the performance could be impacted by abnormal events, like the Covid-19 led crash in March 2020 or the ensuing rally till September 2021.

Hence, a performance analysis conducted on a daily rolling basis will provide a more relevant insight.

Our approach

In our analysis, we try to ascertain that if an investor randomly chooses a fund in a particular category on any date during the year, what are the chances of the fund outperforming the benchmark?

For answering this question, we calculate the returns of all the funds in a category on a daily rolling basis. This means we calculate returns for periods ending 1st January 2012, then 2nd January 2012, then 3rd January 2012, and so on.

Then we see how many funds in that category have outperformed the relevant benchmark on each date. An average is taken across time periods to ascertain outperformance in a category. The final outcome through this analysis for all categories as on 30th September 2021 is presented below

Daily rolling data	1 Year	3 Years	5 Years
Scheme Category	**Avg. % of schemes (Regular Plans) beating the TRI benchmark**		
All Schemes	52.85%	57.49%	62.24%
Largecap	43.63%	45.42%	48.73%
Flexicap	49.16%	55.60%	62.11%
ELSS	53.60%	57.74%	63.68%
Large & Midcap	51.28%	50.82%	56.41%
Midcap	62.39%	69.07%	69.05%
Smallcap	70.47%	81.11%	86.21%
Focused	48.36%	52.86%	61.63%
Value	50.36%	59.04%	68.39%

As can be seen in the table above,

- Except for the Large Cap category, majority of the schemes have outperformed their benchmarks
- The extent of category outperformance is higher over longer time periods.

Union Mutual Fund

Key shortcomings

As in the case of most studies on this subject, this study too has certain shortcomings that we were unable to mitigate. We would like our readers to be cognizant of the same. It is highlighted that the below shortcomings are applicable to both methods of performance analysis stated above viz. single-date analysis and rolling return analysis.

1. **Survivorship bias:**
   Many schemes have been merged into extant schemes post the re-categorization changes that took place in 2018 in the mutual fund industry. Hence, the performance of these merged schemes has not been taken into account.

2. **Style shift due to re-categorization:**
   Certain schemes have changed their strategy to come in line with the new categorization standards. This means that their past performance was achieved through investment strategies that might be different than the category and benchmark they are present in today.

However, we believe that these shortcomings will be limited in certain categories like ELSS.

Conclusions from the study

1. **Prevalent "single date" performance analysis indicates that active funds do not outperform the benchmark.**
2. **However, this type of analysis does not give a complete and reliable insight into portfolio performance as (1) it ignores the performance throughout the year and (2) it is easily biased by abnormal events.**
3. **Rolling return analysis eliminates these biases and provides a more reliable insight into appraising fund performance.**
4. **Rolling return analysis reveals that, on an average, active funds in India have indeed outperformed their respective benchmarks.**

ANNEXURES

Methodology

1. The database considered for our evaluation is from 31st May 2011 onwards (until 30th Sept 2021).
2. 1-year, 3-year and 5-year daily rolling returns are calculated for the period under consideration as mentioned in point 1, for the schemes as well as the indices (Total Return Index data).
3. The excess return is calculated by subtracting the Scheme return by the Index return for that day.
4. We now have, total number of schemes for each day and then calculate the number and percentage of schemes that have outperformed the Index for that day.
5. We then take the average of the total number and percentage of schemes that have outperformed the index for that period and for that category
6. This exercise is carried out for all category of schemes.

Number of schemes across categories

We have conducted the analysis since 31st May 2011 to 30th September 2021. Below is the synopsis of schemes available at the beginning and end of our research period.

Period	1 Year		3 Years		5 Years	
Category	At end date	At start date	At end date	At start date	At end date	At start date
Largecap	29	22	28	19	27	14
Flexicap	25	14	23	12	20	11
ELSS	38	24	35	19	32	14
Large & Midcap	28	19	22	17	22	13
Midcap	26	17	23	17	21	12
Smallcap	23	10	15	9	14	5
Focused	23	11	17	9	15	6
Value	17	13	16	12	14	9
All Schemes	209	130	179	114	165	84

Source: MFI, Union AMC Internal Research.

Disclaimer: The objective of the above study is solely to present an analysis of the performance of active funds vis-à-vis the benchmarks. It is highlighted that the data used for this study is historical data, and that past performance is not an indication of future performance. The information, opinions and facts in this document alone are not sufficient and should not be used for the development or implementation of an investment strategy. Neither the Sponsors/the AMC/ the Trustee Company/ their associates/ any person connected with it, accepts any liability arising from the use of this information. The Sponsors/ the AMC/ the Trustee Company/ their associates/ any person connected with it, do not warrant the completeness or accuracy of the information and disclaim all liabilities, losses and damages arising out of the use of this information. The recipients of this material should rely on their investigations and take their own professional advice.

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