INVESTMENTS

Don't time your equity investments

Inaction is not all bad. Staying invested will generate higher returns in the long term

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There are some investors who believe direct investment in stocks is better than investing in equity mutual funds. They don't believe that fund managers, despite their knowledge, experience, research and bargaining power can create an alpha (returns over and above the indices).

But an examination of the portfolio of such investors may reveal startling facts. Investor No 1, had an equity MF portfolio, which had 179 buy and 304 sell transactions since 1996. The buy transactions could be justified as staggered allocation to equity. Of the sell transactions, some were an effort to exit underperforming funds and re-enter those with better track records and fundamentals; others were attempts to book profits and re-allocate to other asset classes in order to re-align the portfolio with the original strategic asset allocation.

Investors may often experience a momentary imbalance in asset allocation due to unexpected bull runs. For example, if the initial decision was 50 per cent equity and 50 per cent debt as strategic asset allocation, a sudden bull run could see a tilt to 60 per cent equity and 40 per cent debt. In such cases, it would be best to book profits and reduce the equity allocation in order to re-align one's portfolio with the strategic asset allocation of 50:50 debt-equity.

Nevertheless, in the example mentioned above, of the 304 sell transactions, most cases were not profit bookings but attempts to time the market. For example, in 2009 this investor's equity allocation was as low as 20 per cent and in 2012 he reduced it further to 11 per cent of his portfolio. Very few transactions were genuine efforts to re-align to the strategic asset allocation or shift to better-performing funds. Ultimately, the result of playing the market was that investing in equity MFs could not generate good enough returns.

In sharp contrast, Investor No 2 had an entirely different experience. He had been investing in a blue-chip fund (dividend plan) since 2000. After his death in 2007, his family was not sure whether to redeem the funds or transfer them to his daughter. After completing the formalities they discovered that discovered eight unpaid dividend cheques lying in the suspense account. The CAGR of the investment was 18.85 per cent and that the investment had grown about 10 times from the date of investment in July 2000.

There are several such examples where being invested in equity and equity mutual funds for the long term has fetched good returns. So, when there is sufficient evidence that long-term investment will get us what we are seeking, what is it that drives us into making hasty decisions when markets rise and fall?

This can be explained through the example of a research study by Michael Bar-Eli et al*. His analysis of penalty kicks in top soccer leagues and championships worldwide revealed goalkeepers' strange bias toward action. The study reveals that, during a penalty shot, a goalkeeper has approximately 0.2 of a second to decide whether to jump right or left, or stay in the centre. With too little time to register the direction of the kicked ball, a goalkeeper must decide which direction to jump at around the same time when the kicker decides the direction in which to kick the ball.

The study says that about 80 per cent of penalty kicks result in a goal. Given the situation, it claims that the optimal strategy for a goalkeeper would be to hold to the centre (inaction). Yet, it was observed that, most often, a goalkeeper feels compelled to jump to one of the sides. If he chooses to stay in the centre, the inaction would lead to the impression that he did nothing to save a goal. A goalkeeper would much rather appear to be attempting to save a goal than risking doing nothing, something that would jeopardise his career. Utilising this example, the study asserts that investors, too, exhibit similar behaviour in responding to market movements by doing "something" when optimal strategy would suggest staying put.

The magnitude of difference that "staying invested" can make can be exemplified thus. Consider a basket of diversified mutual funds in existence since 1996. Assume your allocations are spread equally across the funds without any selection method. Then compare returns with those of the benchmark Nifty. Had you invested in this basket of funds, your money would have multiplied 23 times (that is, ₹1 lakh invested would have become ₹23 lakh); in terms of compounded returns, you would have earned 18 per cent per annum. Had you invested in equity, the Nifty would have gone up six times, giving you a compounded return of 11 per cent per annum. Moreover, the equity performance compared with that of equity MFs (according to these past returns) would reveal that the MFs basket has outpaced the Nifty by 7 per cent per annum on a compounded basis. This is a 94 per cent outperformance in simple annualised returns per annum, post-tax, post-management-fees.

Apart from the higher returns-generating potential, mutual funds offer a number of advantages such as:

- *Highly Regulated:* The operations of a mutual fund are highly regulated and regularly monitored by SEBI. They are obliged to follow strict regulations designed to protect investors.
- *Transparency:* Mutual funds are required to declare NAVs daily and portfolios monthly. Moreover, performances of mutual funds are reviewed by various publications and rating agencies, rendering it easy for investors to compare one fund with another.
- *Professional Management:* Mutual funds are managed by qualified professionals. Usually, the fund management includes a research team that continuously analyses performances and prospects of companies. Fund houses have stringent risk-management processes in place, which ensure that the team does not take undue risks. This relieves investors from the cumbersome process of tracking performances of companies.
- *Liquidity:* With open-end funds, one can redeem all or part of one's investment any time one wish and receive the current value of the fund. Mutual funds can be more liquid than long-term bonds and fixed deposits.
- *Diversification:* Diversification lowers volatility and the risk of loss by spreading money across different sectors and stocks, which are well researched and tracked.

*Ofer H. Azar, Ilana Ritov, Yael Keidar-Levin and Galit Schein (2005), 'Action bias among elite soccer goalkeepers: The case of penalty kicks', MPRA Paper No. 4477, 15 August 2007, Ben-Gurion University of the Negev and The Hebrew University of Jerusalem, Retrieved 11 August 2014, from: http://mpra.ub.uni-muenchen.de/4477/

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