

MUTUAL FUNDS

# Active funds may not beat index

Though active funds charge 10–50 times the fee of index funds, most do not give remarkable returns

AVINASH LUTHRIA

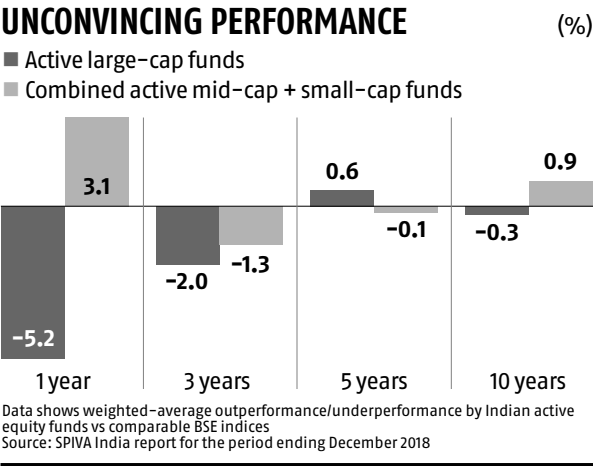
The active mutual fund (MF) industry keeps repeating the statement that ‘the average Indian active MF beats the index and delivers alpha’. And they use various deceptive arguments to support this statement. These, however, are not borne out by data.

The belief in the fairy tale of alpha is dangerous because it will tempt investors to save less for retirement; invest too much in equities believing that an active MF will partially insulate them against a significant stock market crash; be willing to pay a very high fee if an MF can make an exciting case about generating alpha. Let us examine some of the flaws in the arguments put forward by proponents of active investing.

**Focusing on best-performing survivor funds**

Active MFs keep repeating the statement that ‘the average Indian active MF beats the index’. Active MFs’ fees are 10-50 times the fees of the most actively traded Nifty50 ETF. Hence, the onus of proof is on active MFs to prove that their expensive products provide value for money and beat the index.

The only robust analysis of Indian active MF performance is the Standard & Poor’s (S&P) Indices Versus Active Funds (SPIVA) India report (<https://bit.ly/2qOQoeZ>). The SPIVA India report shows that the average Indian active MF does not beat the index. This report has been saying so since the first one appeared in April 2010 for the period 2005-09. And it continues to say so in the latest report for the period 2009-18. The most relevant metric is the weighed-average returns, so we shall focus on that in this article. The cleanest data is for large-cap funds for the past 10 years, and there active MFs underperformed the large-cap index by 0.3



- SOME MISLEADING ARGUMENTS MADE BY PROPONENTS**
- Focusing on the best performing survivor funds to claim that active MFs beat the index
  - Using ambiguous data to claim that active mid and small-cap MFs beat the index
  - Claiming that past data tells you which schemes will beat the index
  - Claiming that distributors can select schemes that will beat the index

per cent per annum (*see table*).

S&P’s additional research ‘The opportunity cost of active management [in India]’ (<https://bit.ly/327NFPc>) shows that the worst-performing schemes get merged into the better-performing ones. This ensures that the data for the worst-performing schemes disappear from MF databases. All the other analyses of Indian MF performance do not correct for this survivorship bias.

**Using ambiguous data**

Proponents of active MFs then argue that ‘large-cap active MFs do not beat the index but mid-cap and small-cap active MFs do so, hence invest in

them’. The higher fee charged by mid-cap and small-cap funds should make one naturally suspicious about this argument. Moreover, it would be very risky to put a disproportionate amount of one’s net worth in mid-cap and small-cap funds, which are more risky than large-cap funds. But let’s focus on the data.

The BSE mid-small cap index returned 18.4 per cent per annum over the 10 years ending 2018. The combined category of mid-cap and small-cap active MFs outperformed it by 0.9 per cent per annum. There are several signs that this 0.9 per cent is just noise in the data. First, over those 10 years, the average mid-small cap

active MF outperformed the BSE mid-small cap index but underperformed the very similar NSE mid-small cap index. Second, these active MFs underperformed even the same BSE mid-small cap index by 0.1 per cent per annum over the five years ending 2018, and by 1.3 per cent per annum over the three years ending 2018. Third, because of the small sample size, S&P had to combine the mid-cap and small-cap categories. So, the data for this combined category is noisier and more ambiguous than the data for the large-cap category. Fifteen years of data would have helped, but no one has high quality data for the Indian

market for 15 years.

**Asking you to pick the right schemes**

Active MF supporters then say that ‘even if the average active MF cannot beat the index, our CIO (chief investment officer) is a genius and hence more than half of our large number of schemes will beat the index. So, pick us’. The S&P’s ‘The Opportunity Cost of Active Management [in India]’ research also shows that knowing which schemes outperformed during the previous five years will not help you select schemes that will outperform during the coming five years. Since luck or randomness has a huge impact, it is difficult to determine whether past outperformance was due to luck or skill. So, it is very difficult to figure out which of the hundreds of schemes will outperform the index over the next 5-10 years.

Active MF proponents’ final line of defence is that ‘a distributor can tell you that our CIO is a rare genius and also figure out which of our schemes are likely to beat the index’. The distributor would have to be a genius indeed to be able to figure all this. So, this just changes the problem to finding a distributor who is a genius. Bear in mind that the annual commission of the distributor will make it even more difficult for the investor to outperform the index. Due to lack of space, I have omitted many of the other arguments in favour of active MFs that are even more spurious.

Nobel prize winner William Sharpe proved mathematically that the average active investor is, net of costs, guaranteed to underperform the index. Further, promoters of companies have the most amount of information, so they are likely to be the above-average active investors. Hence, it is difficult for the average MF to be an above-average active investor. This is the rationale for index funds — the greatest financial innovation of the last century. Nine-and-a-half years since the publication of the first SPIVA India report ought to have been long enough for Indian individual investors to get over the delusion that they are above average investors and exit the cult of alpha.

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BS TUTORIAL

Jayant Pai  
**Financial literacy**

1. Which US politician made the term Modern Monetary Theory popular again?  
A. Bernie Sanders  
B. Elizabeth Warren  
C. Alexandra Ocasio-Cortez  
D. Joe Kennedy
2. Which country topped the World Economic Forum (WEF) competitiveness ranking recently?  
A. Netherlands  
B. Singapore  
C. Sweden  
D. Canada
3. Which country, affected by the 2008 financial crisis, has yet not been able to borrow at negative yields?  
A. Portugal  
B. Italy  
C. Spain  
D. Greece
4. Which Indian real estate company does not have any tie-up or agreement with the Trump Organisation?  
A. Panchshil Realty  
B. Lodha Group  
C. M3M India  
D. Godrej Properties
5. Who was the first 'non-economist' to win the Nobel Prize for Economics?  
A. John Nash  
B. Daniel Kahneman  
C. Herbert Simon  
D. Elinor Ostrom

**Solutions**

1. C. She maintained earlier this year that Modern Monetary Theory – which maintains that any government does not need to balance the Budget and budget surpluses are actually harmful – needed to be part of a larger conversation.

2. B. Singapore scored 84.80 points while the US was second with 83.70 points.

3. A. The lowest rate it has been able to borrow at, so far, is 0.49 per cent a year. All the other three have been able to borrow at negative yields in 2019 despite their creditworthiness being badly damaged by the crisis of 2008.

4. D.

5. C. He won it in 1978 for his pioneering research into the decision-making process within economic organisations.

*The quiz master is head-marketing, PPFAS Mutual Fund  
Send your queries and feedback at yourmoney@bsmail.in*

## ECONOMY

### E-COMMERCE, BITCOIN FRAUDS UP Police to expand cyber crime wings



VIRENDRA SINGH RAWAT  
Lucknow, 12 October

Taking note of the growing cases of online frauds, the Uttar Pradesh (UP) government has decided to set up a multi-tiered specialised cyber wing, which will taper down to the police station level.

The cyber cells will investigate a gamut of online frauds, involving e-commerce, digital currency (such as bitcoin), credit cards and e-wallets.

The cyber wing will have presence at police stations, districts, zones and headquarters for effective investigation of online crimes and speedy disposal of such cases.

UP Director General of Police (DGP), O P Singh, has issued instructions to senior officials, including zonal additional DGPs, inspector general of police (IG) and range deputy IGs, senior superintendents of police (SSPs) and SPs to complete the preliminary rollout of the cyber cells by October 15.

The cyber wing will comprise a ‘cyber crime team’ at the police station, manned by a police inspector, a sub inspector and two head constables. It will investigate cases of frauds involving ATM, credit card, e-wallet, fake profile and password hacking.

Similarly, the ‘district cyber crime cell’ will handle more serious online offences, such as e-commerce, fake Twitter handle, website defacement, prizes/lotteries etc.

A cyber crime investigation team and a cyber crime support team will also function at the district level to assist local cyber cells. They will have four police personnel, including

inspector, sub inspector and two head constables. The cell would also monitor the social media platforms for possible misuse and targeting of gullible users. The cell will further organise interactive programmes in schools and colleges to create awareness among students on the topic of cyber offences. As per the cyber wing roadmap, crime branch assistant SP/deputy SP would be in the charge of the district level cyber cell and report to the district SP.

Meanwhile, the cyber cell at the zone level will investigate more complex and grave cyber crimes, including data theft, ransomware, digital/cryptocurrency, dark web, cyber terrorism, online extortion etc. A zonal cyber crime investigation team and a zonal cyber crime support team would assist zonal cyber arms in investigation. A state-level cyber cell is already operational at the UP Police headquarters, which would monitor the functioning of all the zonal, district and police station level arms.

Currently, specialised cyber police stations are functioning at Lucknow and Noida (Gautam Budh Nagar district). Taking cognisance of the growing instances of such cybercrimes, there is the proposal to set up 6 more specialised cyber police stations at Agra, Kanpur, Bareilly, Varanasi, Gorakhpur and Prayagraj (Allahabad) to cover all 8 police zones. Lucknow and Noida fall under Lucknow and Meerut zone respectively. Last year, the state’s DG O P Singh had also observed that proliferation of internet had widened the scope of cybercrimes.

### Prasad cites success of 3 films to deny economic slowdown

PRESS TRUST OF INDIA  
Mumbai, 12 October

Indications of slowdown notwithstanding, Union minister Ravi Shankar Prasad (*pictured*) on Saturday said three Bollywood movies generating business of ₹120 crore on the October 2 holiday suggested the “sound economy” even as he dubbed “wrong” the NSSO report which had reportedly pegged unemployment rate at 45-year high in 2017.

Days after the International Monetary Fund (IMF) said the economic slowdown is more pronounced this year in India and Brazil, Prasad said the measurement was incomplete.

He alleged that some people organised against the government are misleading people over unemployment scenario.

“I was also told that on October 2, which is observed as one of the national holidays, three Hindi movies garnered ₹120 crore business on that day. Unless the economy is sound in the country how can only three movies collected so much business in a single day?” Prasad asked while speaking to reporters.

He was in Mumbai to campaign for the BJP for the October 21 Maharashtra assembly polls.

The National Sample Survey Office’s (NSSO’s) periodic labour force survey (PLFS) had stated that unemployment was 45-year low. It had stated that the rate was this high in 1972-73 and 2.2 per cent in 2011-12.

The report had generated a lot of political heat, with the then Congress president Rahul Gandhi saying the Modi government had promised two crore jobs, but five years later a “leaked job creation report card” has revealed a “national disaster”.

Earlier, NITI Aayog Vice-Chairman Rajiv Kumar had countered the report saying, “It is not finalised. It is a draft report.”

Prasad, who holds Law and Justice, Communications and Electronics and Information Technology portfolios, said, “I have given you ten parameters where economy is performing well, but not a single one is reflected in the (NSSO) report. Hence I call it a wrong report.”



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## Modi, Xi agree to set up new trade mechanism

At their delegation-level talks, Xi spoke of informal summits having produced visible progress and invited Modi for a third such summit to China next year. “The Wuhan summit instilled a new momentum and trust in our relations and today’s ‘Chennai Connect’ is the start of a new era in India-China relations,” Modi said.

Briefing the media after the Chinese president left India for Nepal, Foreign Secretary Vijay Gokhale said the two leaders had a “good conversation on trade”, which he said was of “concern” in India.

The Chinese president told Modi that Beijing was “ready to take sincere action in this regard and discuss in a very concrete way how to reduce the trade deficit”. Xi welcomed India’s investments into China in IT and pharmaceutical sectors.

The two also discussed the ongoing RCEP negotiations in Bangkok, with Modi “specifically” stating that while India looked forward to the free trade pact, it was important that it was balanced, and that balance was maintained between trade in goods, trade in services and investments.

According to Gokhale, the Chinese president said Indian concerns would be taken into account.

The Indian side “categorically” said the Kashmir issue, a cause of tension between New Delhi and Beijing since August 5, did not come up for discussion. However, the Chinese president spoke with Modi about the visit of Pakistan PM Imran Khan to Beijing earlier this week.

On whether the issue of approval for Chinese telecom equipment firm Huawei for 5G trials was discussed, Gokhale said it was not, but the new mechanism would discuss private and public sector investments in both countries.

Chinese Ambassador to India Sun Weidong said the summit was a “big success”. “From Wuhan to Chennai, from Yangtze river to Ganges, China and India join hands and stand together. Dragon and elephant have a tango,” he tweeted.

Xi and Modi also discussed regional and international issues. Gokhale said “both emphasised the importance of independent and autonomous foreign policies” and Xi said many more intensive discussions were needed between the two sides to understand each other’s perspectives on global and regional issues.

The Chinese president stressed the need to step up engagement in defence and security areas to enhance mutual trust between the two militaries and security forces. The Chinese side invited the defence minister for a visit to China. The two leaders also spoke of strengthening people-to-people contacts.

The two leaders discussed the challenge of radicalisation and terrorism that the two countries face, the status of India and China’s boundary dispute, and climate change. The two sides agreed to work on increasing links between Tamil Nadu and the Fujian province of China.

The two leaders shared the view that the international situation was witnessing a significant readjustment, and India and China had a common interest in preserving

and advancing a rules-based and inclusive international order, including through reforms that reflect the new realities of the 21st century.

“Both agreed that it is important to support and strengthen the rules-based multilateral trading system at a time when globally agreed trade practices and norms are being selectively questioned. India and China will continue to work together for open and inclusive trade arrangements that will benefit all countries,” a statement from the Indian side said.

They also agreed on the importance of concluding negotiations for a mutually-beneficial and balanced Regional Comprehensive Economic Partnership, it said.

Xi left Mamallapuram at around 12:45 pm for the Chennai airport, wrapping up the nearly 24-hour trip, and from there to Nepal, the first visit of a Chinese president to Nepal in 23 years.

**Modi’s TN outreach**

Tamil Nadu has assembly polls in 2022. The Bharatiya Janata Party (BJP) has struggled to make inroads in the state. On the first day of the summit, the PM donned a veshti and angavastham, traditional attire of the state.

On Saturday, the PM tweeted in English and Tamil thanking “all political parties and socio-cultural organisations of Tamil Nadu” for their support to the summit and their hospitality. In the morning, he tweeted pictures of his taking a walk on the Mamallapuram beachfront, and also a video of him picking garbage.

### Regulatory battle...

The average wind power tariff in the state is Rs 4.8/unit and solar is Rs 4.5/unit.

The discoms have filed a third petition with regard to another group of 82 wind energy producers who have entered PPAs following another tariff regulation in 2015, seeking similar tariff revision orders from the regulator.

The discoms have stated that the power sector in the state has entered into a deep financial crisis as the high cost renewable energy purchases were adding ₹2,500 crore to their losses every year.

“We could not even pay monthly power purchase bills from August 2018, which have piled up to nearly ₹20,000 crore,” the said the petition of the discoms.

At the same time, renewable power producers have alleged that the state is curtailing this power segment since the tussle began in July.

Government officials claimed to this paper that the state never gave any orders of curtailment of renewables and it is governed by the Regional Load Despatch Centre. “There is no official record of state government ordering any curtailment,” said a senior official.

Meanwhile, the central government has been urging the state not to cancel any PPA or review the tariff. On Friday, at the State Power Ministers’ Conference being held in Gujarat, Union power minister R K Singh reiterated that states should honour the PPA they sign. Referring to Andhra, he said, “One state breached terms of power purchase agreement and five different ambassadors got in touch with me,” he said.

Sources said the energy department of Andhra Pradesh, which participated in the deliberations during the conference, did not reply or agree to the request of the Centre. State government officials said they were honouring the high court’s order to let the regulator take a decision in the matter.

### Future Retail...

Future Retail said on Saturday it would fund the acquisition of retail assets through existing channels available to it, including equity and debt. It would not raise fresh funds for the deal.

The company also said approval of its members would be sought at an extraordinary general meeting, to be held in Mumbai on November 8.

### India’s biggest...

At the 2018 meet, Sunil Mittal had expressed concern over challenges such as high taxes and spectrum charges in the sector, while Mukesh Ambani had opted to talk about connecting everybody at the most affordable rates. On Monday, if Ambani and Mittal don’t turn up, shutterbugs may be disappointed even as they track as many as 36 sessions and 250 plus speakers through the next three days.