CHAPTER – 9
IMPACT OF PORTFOLIO MANAGEMENT ON THE INVESTORS’ HOME

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IMPACT OF PORTFOLIO MANAGEMENT ON THE INVESTORS’ HOME:

*Diversification – Basic Concept:*

Diversification is a basic tenet of investing. Diversification can be defined as:

1. The act or process of diversifying; state of being diversified.
2. The act or practice of manufacturing a variety of products, investing in a variety of securities, selling a variety of merchandise, etc., so that a failure in or an economic slump affecting one of them will not be disastrous.

The key phrase about diversification listed above is:

"...so that a failure in or an economic slump affecting one of them will not be disastrous."

In other words, don’t put all of your eggs in one basket.

Diversification is one of the many advantages of investing in mutual funds. When it comes to diversification, mutual funds can help an investor in two ways:

First, the beauty of mutual funds is that an investor can invest a few thousand rupees in one fund and obtain instant access to a diversified portfolio. Otherwise, in order to diversify one’s portfolio, he/she might have to buy individual securities, which exposes him/her to more risk. In other words, a mutual fund allows an investor to diversify into many different stocks for a nominal investment.

Sometimes, when it comes to diversification, it’s not good enough to simply own many different stocks. For example, if you own 100 stocks within a mutual fund, and those 100 stocks are in the financial sector (a sector mutual fund), more than likely as the financial sector moves up and down, so does the value of your mutual fund. That brings us to the second point. A mutual fund also allows for diversification between various styles, sectors, countries, etc. An investor can either buy a mutual fund that is broadly diversified, or he can buy a portfolio of mutual funds across various sectors -- creating his own diversification.
Thus, a mutual fund allows for diversification between many different stocks and also allows for diversification between various sectors, styles, etc. This diversification allows investors to reduce the risk of one particular stock or sector, but also allows for more potential reward by offering a broader exposure to various stocks and sectors.

**Reasons to buy a Mutual Fund:**

There are many reasons to buy a mutual fund, few among them are discussed as under:

**Mutual Funds offer diversification:**

The beauty of a mutual fund is that an investor can buy a mutual fund and obtain instant access to a hundreds of individual stocks or bonds. Otherwise, in order to diversify his portfolio, he might have to buy individual securities, which exposes him to more potential volatility.

**Mutual Funds are professionally managed:**

Many investors don’t have the resources or the time to buy individual stocks. Investing in individual securities, such as stocks, not only takes resources, but a considerable amount of time. By contrast, mutual fund managers and analysts wake up each morning dedicating their professional lives to researching and analyzing current and potential holdings for their mutual fund.

**Mutual Funds come in many varieties:**

A mutual fund comes in many types and styles. There are stock funds, bond funds, sector funds, target-date mutual funds, money market mutual funds and balanced funds. Mutual funds allow investor to invest in the market whether he believes in active portfolio management (actively managed funds) or he prefers to buy a segment of the market with no interference from a manager (passive funds and index mutual funds). The availability of different types of mutual funds allows an investor to build a diversified portfolio at low cost and without much difficulty.
**Mutual Funds have low minimums:**

Many mutual fund companies allow investors to get started in a mutual fund with as little as Rs. 500.

**Systematic investing and withdrawals with Mutual Funds:**

It is simple to invest regularly in a mutual fund. Many mutual fund companies allow investors to invest as little as Rs. 500 per month directly into a mutual fund. Money can be pulled directly from a bank account and invested directly in the mutual fund. On the other hand, money can be regularly withdrawn from a mutual fund and be deposited into a bank account. There are generally no fees for this service.

**Mutual Funds offer automatic Reinvestment:**

An investor can easily and automatically have capital gains and dividends reinvested into their mutual fund without a sales load or extra fees.

**Mutual Funds offer Transparency:**

Mutual fund holdings are publicly available (with some delays in reporting), which ensures that investors are getting what they pay for.

**Mutual Funds are liquid:**

If an investor wants to sell his mutual fund, the proceeds from the sale are available the day after you sell the mutual fund.

**Mutual Funds have audited Track Records:**

A mutual fund company must maintain performance track records for each mutual fund and have them audited for accuracy, which ensures that investors can trust the mutual fund’s stated returns.

**Safety of Investing in Mutual Funds:**

If a mutual fund company goes out of business, mutual fund shareholders receive an amount of cash that equals their portion of ownership in the mutual fund. Alternatively, the mutual fund’s Board of Directors might elect a new investment advisor to manage the mutual fund.
**Mutual Fund Diversification:**

Mutual funds are wildly popular with investors because they offer instant investment diversification. A mutual fund is a collection of stocks and bonds managed by a team of professional investors and money managers. The professionals do all of the research for investors. They pick and choose assets that achieve a desired ratio of risk and growth potential. Even better, mutual funds rebalance themselves.

Mutual funds have their disadvantages, too. Not all mutual fund managers are created equal, so there's no guarantee that investors' collection of stocks and bonds will make money. Also, not all mutual funds are cheap. Many carry lots of sneaky commissions and hidden fees with disarming names like "back-end loads".

Few of the commonly available mutual funds in the market are as under:

**Equity funds:**

Equity funds are mutual funds that are composed mostly of stocks and are allocated for long-term growth. Within equity funds are a number of subcategories:

- **Index funds** are designed to closely mimic a popular stock market index like the S&P 500. As the market goes, so does the mutual fund.
- **International funds** can either include different stocks from around the world or stocks concentrated in a specific global region.
- **Sector funds** stick to a particular industry like health care or high tech. They are considered risky because so many of your eggs are in one basket.

**Income mutual funds** are less risky than equity funds. They invest in mostly government and corporate bonds and are designed for people who are willing to sacrifice growth potential for a steady dividend paycheck.

**Money market** accounts are also a type of mutual fund that only invests in the most conservative security: U.S. Treasury Bills.

**Targeted maturity funds** are designed for investors who are saving for a particular time-sensitive goal like retirement or paying for a college education. With
names like "Target Retirement 2040," these mutual funds are automatically balanced and allocated to maximize return and secure your earnings by 2040.

**Capital protection - oriented funds (CAPRO):**

Capital protection – oriented funds are mutual funds with an objective to seek capital protection by investing in fixed income securities maturing in line with the tenure of the scheme and seeking capital appreciation by investing in equity and equity related instruments. As the name suggests, these funds will 'TRY' to protect the capital but there is no guarantee.

The Mutual Fund people are not astrologers. They can't see the future. Yes, they will do research and invest money in companies which are 'expected' to do well in the future. The future, as we have repeatedly seen, can however spring lots of surprises - both good and bad. Hence, they can't protect capital by trying to read the future.

Nor are the Mutual Fund people philanthropists, who will put in their own money in case the portfolio suffers a loss and pay investors back at least their capital.

What they will do is actually very simple. From Rs.100 of the investor, they will invest say about Rs.70-80 in debt. The balance about Rs.20-30 will go into equity. In 3-5 years (the usual tenure of these schemes), Rs.70-80 will appreciate to about Rs.100.

Therefore, even if the entire Rs 20-30 invested in equity is lost, investor at least get back Rs 100. Hence, capital is protected. They are practically no different from the very familiar 'Monthly Income Plan' schemes.

The only difference is that these are close-ended funds and hence get time to grow their debt portfolio from Rs 70-80 to Rs 100 and also give the much-needed 'time' to the equity component to prosper.
Of course, Mutual Funds may use sophisticated tools to decide on the right mix of debt and equity from time to time.

There is one issue - the returns. If, like most people, investor assume that he can expect 40-50 per cent equity-like returns, while at the same time protecting his capital, then he is wrong. Remember, there's no free lunch. The returns from such funds will be limited. Assuming that equity gives around 30 per cent returns p.a. over the next 3 years, then Rs 20 would have become Rs 44.

At the same time, Rs 80 in debt would have become Rs 100 (@8% p.a.). Thus, Rs 100 would have appreciated to Rs 144 in 3 years, i.e. about 13 per cent returns p.a.

Given the uncertainty witnessed by the markets in the past few months, it's no surprise that nine capital protection-oriented funds have been launched since January, 2013 and more such offerings are in the pipeline.

**Monthly Income Plan (MIP):**

Monthly income plan (MIP) is an investment vehicle whereby an investor receives a set monthly payment typically used by that individual as a source of income. These types of plans are helpful for retirees in that they ensure that the investor will receive a regular income without the need to make sporadic or random withdrawals from their retirement savings in order to pay for their living expenses.

**Fixed Maturity plan (FMP):**

Fixed maturity plan (FMP) is a closed-end fund that invests in debt and money market instruments of the same maturity as the stated maturity of the plan. The focus of a fixed maturity plan is to provide a stream of income through interest payments, while exposing the investor to a lower level of risk.

**Exchange Traded Funds (ETF):**

In the financial media outside India, it has been noted that January 2013 marked the 20th anniversary of exchange traded funds (ETFs). In the western financial markets, ETFs have been an extremely useful and efficacious financial
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innovation, rewarding both its providers and investors as well. In fact, ETFs are the one exception to the red-flag phrase that ‘financial innovation’ has become. Unlike much of what passes for innovation in investing, ETFs have greater transparency, as well as lower costs and better returns for the customer. For many smart investors, ETFs have become the only way they’ll invest in equity as well as other assets.

Unfortunately, ETF’s haven’t taken hold in India. Eleven years after the first ETF was launched by Benchmark MF (now acquired by Goldman Sachs), a mere 1.8% of India’s mutual fund assets are in ETFs. In fact, a good part of this too is actually gold ETFs, which for a long time was the only way of investing in a gold fund. If one looks at equity alone – the measure of how investors have actively opted for ETFs then its far worse – just 0.22% of equity assets are in equity ETFs. The equivalent figure in western markets is 16%. Clearly, ETFs have been a non-starter in India.

In fact, ETFs are low–cost and passive fund management as they don’t require investment management in the normal sense. There isn’t a fund manager who is responsible for deciding what to invest in. Instead, the fund is a replica of a market index.

While this is true of all index funds, exchange traded funds (ETFs) are a special case of index funds. They are mutual funds but are bought and sold like shares. When an investor wants to buy or sell one, he does not go to a mutual fund salesman but to a stockbroker. Unlike a normal mutual fund where investor buy and sell units from the fund company itself, ETF units are traded on the stock markets between investors. However, the fund company arranges to absorb any excess supply of units that an investor would like to sell or create fresh units when the demand for units is large enough. As a result, unlike normal shares, the trading price of ETFs is not supposed to be heavily impacted by demand-supply imbalances.

ETFs are inherently very low-cost funds. While an actively-managed mutual fund often deducts expenses of up to 2.5%, for ETF’s the figure is far lower. In India, most ETF expenses are in 0.5% to 1% range, but for large ETFs’ it can be
much lower. With compounding, this can build up to a significant difference over time.

The reason for lower expenses is that the fund management cost is negligible. The lack of active fund management turns out to be a practical advantage for the customer. There’s no scope for doing better or worse than the index, so fund selection doesn’t matter. Diversification is automatic and assured, regardless of whether you invest in one fund or five.

Unfortunately, the flipside of the low cost is that ETFs don’t make much money for the fund companies and the distributors. They have taken off in the West because of much higher competition and the presence of large institutional fund investors. Such investors are more focused on cost and less swayed by marketing hype. In India, a vast majority of equity fund investors are individual retail investors, to whom funds have to be pushed. And the push is naturally not for low-margin products like ETFs, and even index funds.

**Investment in gold ETFs slowed in 2012:**

The robustness of an investment portfolio plays a significant role in the achievement of goals. Among asset classes, gold is considered the most robust as it counters the effects of inflation and exchange rate fluctuations.

If one considers gold's performance vis-a-vis equity in the past five years, the latter, as measured by the BSE Sensex, has delivered an annualised return of just 2.67%. Compare this with gold, which has delivered 27.19% annualised return over the same period.

The year 2012, that saw a comeback for equities, was otherwise a rather subdued year for gold. With yellow metal registering a mediocre 10.7% growth in value in the past one year against 24% to 26% gains made by the Sensex and the Nifty respectively last year, investors too have shied away from investing in the yellow metal.
According to data by mutual fund association AMFI, the growth in the number of retail investors or folios of Gold ETFs by during the Sep '11 to Sep '12 period was a mere 15% from 4.12 lakh folios to 4.75 lakh folios during these 12 months. This is highly subdued as compared with 75% growth in the number of retail folios registered from Sep '10 - Sep '11 period or 137% growth registered a year before that.

Apart from a high price tag of over Rs 30,000 per 10 grams that has taken the yellow metal beyond the reach of many investors, the fact that equity markets are today offering far superior returns has also taken away some of its shine. The BSE Mid cap index, for instance, has been one of the better performing indices on the bourses with close to 40% returns for the year - four times that of Gold returns in 2012.

But having said that, investors, who had earlier burnt their hands in the financial crisis of 2008 by investing in equities, are yet to come back to this asset class. Despite the handsome gains being made by equities, the number of equity folios in the mutual fund industry has been on a consistent decline since Mar '09 from 4.1 crore in Mar '09 to 3.5 crore in Sep '12.

**Systematic investment plan (SIPs):**

SIP is not a product or a fund. It is simply an investment process. Instead of basing investment decisions on expectations of how the market will behave, SIPs facilitate a disciplined participation in the market through ups and downs. Many investors believe that if they invest through SIPs, they will earn better returns. That is not true. The returns will depend on how the fund has performed at all times.

**Systematic investment plan (SIPs) – Facts and Fiction:**

- Systematic investment plan funds have marketed this idea of disciplined investing successfully. The biggest merit of a SIP is that it allows one to invest regularly without being bogged down by questions about the right time to jump in.
Since a fixed amount is invested across time, SIPs enable a reduction in average cost. Therefore, the returns from an SIP are not likely to be different from those of the mutual fund in which the investment is made.

The benefit of this option has to be measured across cycles. If an investor invests via SIP as the NAVs are moving up, then while computing his return, he will value all his SIPs at the current NAV, which would be higher than the cost of acquisition. Sure enough, SIPs will look good. However, in a falling market, all SIPs will be valued at the lower NAV, and hence, will look bad. The returns are measured on the basis of where investor stand today and that will bias his gain or loss. If the investor persist across cycles, his investment in both the equity and SIPs will look good.

There is no point in comparing lump-sum investments and SIPs. There have seen strenuous research in recent times trying to establish when and under what conditions a SIP can beat lump-sum investment. Actually, they are two completely different ideas, and the latter will typically beat SIPs. When an investor invests a lump sum, a larger chunk of his money works for a longer period of time. On the other hand, a SIP is a slow model, where an investor builds his wealth with each installment. Example: Had you invested Rs 10,000 per month in the Sensex since its inception in 1979—406 months in all—you would have about Rs 1.6 crore today.

A lump-sum investment of the same amount, Rs 4.06 lakh at that time would be worth over Rs 8 crore today. If you have a lump sum handy, you are better off not trying to go for an SIP unless you think the market is falling and you want to invest at lower levels.

SIPs are not about smart market timing; they simply allow to invest regularly. If investor is a salaried person with a regular income and monthly saving, SIPs are just the thing for him. Thus, SIPs enable an investor to be disciplined in his investing. Without one, he may not even have participated in the down market.

SIP in a debt fund is not a great idea, especially when an investor wants to invest a lump sum. A debt fund earns steady and regular interest income. The lesser investor participate, the lesser he earn. In equity, the market cycles
may modify investors’ benefits in the short term, but with a debt fund, holding a lump sum to invest, and then choosing a SIP is clearly inefficient.

- Cancelling a SIP in a down market amounts to underweighing equity in a bear market. If an investor choose to come back when the market moves up again, he is invariably coming in at a higher NAV, and lose the benefit of having invested at the bottom. Money moves with the market in a SIP, and when investor leave and join at will, he indulge in trying to time the market. When this attempt converts into buying at peaks and selling at the bottom, there is no money to be made.

**Sectoral diversification:**

*Mutual funds exposure to banking stock soars to over 3-year high:*

The mutual fund industry is betting big on banking space with equity investments worth over Rs 43,000 crore, the highest level in over three years.

According to latest data available with the SEBI data, mutual fund industry's investment in banking stocks stood at Rs 43,659 crore at the end of December, which was 21.15 per cent of the industry's total equity assets under management (AUM) of Rs 2.06 lakh crore.

Banking is the only sector to log double digit exposure. Software is the second most preferred sector with MFs having 7.98 per cent exposure, followed by pharmaceuticals (7.59 per cent) and consumer non-durables (7.51 per cent).

At current levels, the MF industry has the highest exposure to banking sector since at least August 2009 both in terms of percentage as well as in absolute terms.

Data is not available for sector-wise mutual fund exposure before August 2009, when the equity funds had deployed Rs 22,587 crore (12.73 per cent) in banking sector.

The mutual funds had pumped in Rs 42,022 crore in the banking shares at the end of November, while their exposure in the sector was at 20.59 per cent of the equity AUM.
The year 2012 has seen a consistent growth in investment in banking stocks by the industry's equity fund managers and their exposure has risen from 17.23 per cent of total AUM in January 2012 to 21.15 per cent in December. In absolute terms, fund infusion has grown from Rs 32,380 crore to Rs 43,659 crore.

Market experts believe that expectation of rate cuts from Reserve Bank of India (RBI) has made equity fund managers raise their exposure in the sector.

A steady rise in investment in bank shares is seen in the last three months by mutual funds on expectation of a reduction in key short-term lending rate by RBI in January.

Additionally, the passage of the Banking (Amendment) Bill, which paves the way for entry of more players and investments in the sector, had also given a boost to the sector.

In December, banking was followed by software sector which have attracted Rs 16,467 crore or 7.98 per cent of AUM, pharmaceuticals saw an investment of Rs 15,667 crore or 7.58 per cent of AUM and consumer non durables witnessed a deployment of Rs 15,498 crore or 7.51 per cent of the AUM.

In January’2013, The Reserve Bank had cut short-term lending rate called repo by 0.25 per cent to 7.75 per cent and also slashed Cash Reserve Ratio, which is the portion of deposits that banks have to park with the central bank, by similar margin to 4 per cent.

Classification of mutual funds:

Mutual Funds can also be broadly classified into various categories under the following heads:

(A) According to the type of investments:

While launching a new scheme, every Mutual Fund is supposed to declare in the prospectus the kind of instruments in which it will make investments of the funds collected under that scheme. Thus, the various kinds of Mutual Fund schemes as categorized according to the type of investments are as follows:
(a) Equity funds / Schemes  
(b) Debt funds / Schemes (also called Income Funds)  
(c) Diversified funds / Schemes (also called Balanced Funds)  
(d) Gilt funds / Schemes  
(e) Money market funds / Schemes  
(f) Sector specific funds  
(g) Index Funds

(B) **According to the time of closure of the scheme:**

While launching new schemes, Mutual Funds also declare whether this will be an open ended scheme (i.e. there is no specific date when the scheme will be closed) or there is a closing date when finally the scheme will be wind up. Thus, according to the time of closure, schemes are classified as follows:

(a) Open ended schemes  
(b) Close ended schemes

Open ended funds are allowed to issue and redeem units any time during the life of the scheme, but close ended funds cannot issue new units except in case of bonus or rights issue. Therefore, unit capital of open ended funds can fluctuate on daily basis (as new investors may purchase fresh units), but that is not the case for close ended schemes. In other words we can say that new investors can join the scheme by directly applying to the mutual fund at applicable net asset value related prices in case of open ended schemes but not in case of close ended schemes. In case of close ended schemes, new investors can buy the units only from secondary markets.

(C) **According to tax incentive schemes:**

Mutual Funds are also allowed to float some tax saving schemes. Therefore, sometimes the schemes are classified according to this also:

(a) Tax saving funds  
(b) Not tax saving funds / other funds
According to the time of payout:

Sometimes Mutual Fund schemes are classified according to the periodicity of the pay outs (i.e. dividend etc.).

The categories are as follows:

(a) Dividend Paying Schemes

(b) Reinvestment Schemes

The mutual fund schemes come with various combinations of the above categories. Therefore, one can have an Equity Fund which is open ended and is dividend paying plan. Before investing, one should choose a scheme as per his risk capacity and the regularity at which he wish to have the dividends from such schemes.

The table below gives an overview into the existing types of schemes in the Industry:

- **By Structure**
  - Open - Ended Schemes
  - Close - Ended Schemes
  - Interval Schemes

- **By Investment Objective**
  - Growth Schemes
  - Income Schemes
  - Balanced Schemes
  - Money Market Schemes

- **Other Schemes**
  - Tax Saving Schemes
  - Special Schemes
    - Index Schemes
    - Sector Specific Schemes
**Fund of funds (FOF): Meaning, Features and considerations:**

**Meaning:**

A "fund of funds" (FOF) is an investment strategy of holding a portfolio of other investment funds rather than investing directly in stocks, bonds or other securities. This type of investing is often referred to as multi-manager investment. A fund of funds may be 'fettered', meaning that it invests only in funds managed by the same investment company, or 'unfettered', meaning that it can invest in external funds.

There are different types of 'fund of funds', each investing in a different type of collective investment scheme (typically one type per FoF), for example 'mutual fund' FoF, hedge fund FoF, private equity FoF or investment trust FoF but the original Fund of Funds was created at First London Securities PLC.

**Features:**

Investing in a collective investment scheme may increase diversity compared to a small investor holding a smaller range of securities directly. Investing in a fund of funds may achieve greater diversification. According to modern portfolio theory, the benefit of diversification can be the reduction of volatility while maintaining average returns. However, this is countered by the increased fees paid on both the FoF level, and of the underlying investment fund.

An investment manager may actively manage with a view to select the best securities. A FoF manager will try to select the best performing funds to invest in based upon the managers past performance and other factors. If the FoF manager is skillful, this additional level of selection can provide greater stability and take on some of the risk relating to the decisions of a single manager. As in all other areas of investing, there are no guarantees for regular returns. As a fund of funds invests in the scheme of other funds, it provides a greater degree of diversification. Instead of investing in different stocks of mutual funds and keeping records of all of them, it is much easier to invest and track only one fund which in turn invests in other mutual funds.
Considerations:

Management fees for Funds of Funds are typically higher than those on traditional investment funds because they include the management fees charged by the underlying funds. As in the case of schemes of mutual funds, FOF schemes also work under the due diligence of a fund manager. This gives the scheme an additional expertise. It also helps to provide access to information which may be difficult to obtain information by an investor on a case by case basis. Every fund manager has a particular style of diversification. This diversification has a perfect correlation with the number of managers involved. Once a FOF reached a certain level of managers, adding more flattens return curve and diversifies away alpha. Since a fund of funds buys many different funds which themselves invest in many different securities, it is possible for the fund of funds to own the same stock through several different funds and it can be difficult to keep track of the overall holdings.

Funds of funds are often used when investing in hedge funds and private equity funds, as they typically have a high minimum investment level compared to traditional investment funds which precludes many from investing directly. In addition hedge fund and private equity investing is more complicated and involves higher risk than traditional collective investments. The lack of accessibility favors a FoF with a professional manager and built-in spread of risk.

Pension funds and other institutions often invest in funds of hedge funds for part or all of their "alternative asset" programs, i.e. investments other than traditional stock and bond holdings.

After allocation of the two levels of fees payable and taxation, returns on FoF investments will generally be lower than single-manager funds.

The due diligence and safety of investing in FoFs has always been questioned.
Are investors home biased?

With higher value placed on more accessible information, the balance is changed and a bias emerges. What may seem to be small differences can add up to an important investment result - money stays at home. This phenomenon - called “home bias” - is well known in financial analysis: investors strongly tilt their portfolios toward domestic assets and away from foreign instruments.

Thus, home bias is the tendency for investors to invest in a large amount of domestic equities, despite the purported benefits of diversifying into foreign equities. This bias is believed to have arisen as a result of the extra difficulties associated with investing in foreign equities, such as legal restrictions and additional transaction costs.

Investing in foreign equities tends to lower the amount of systematic risk in a portfolio because foreign investments are less likely to be affected by domestic market changes.

However, investors from all over the world tend to be biased toward investing in domestic equities. For example, an academic study from the late 1980s showed that although Sweden possessed a capitalization that only represented about 1% of the world’s market value of equities, Swedish investors put their money almost exclusively into domestic investments.

“When managers differ in their ability to generate substantial returns, and investors do not know this ability but learn about it by observing past performance, investors will learn faster about the domestic funds.” Therefore, the domestic funds will be less risky for the investors. As a result, investors will channel more money to the domestic funds.

There is a simple explanation for home bias in individual investment – investors have better information about their domestic economy than about foreign ones.

Portfolio managers can carry this home bias in investment up to the level of mutual funds, based on small amounts of market performance information
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distributed asymmetrically among individual investors. Domestic information is cheap information. But it is puzzling that home bias persists even when the investment is undertaken by mutual funds, which are capable of accessing and analyzing information from virtually any source with equal effectiveness.

Almost all information is available to an investor who has time and resources to get it. The problem is that some information is much ‘cheaper.’ While reading domestic newspapers, watching domestic TV, and talking to friends, individual investors easily receive information about how the domestic economy is doing. They don’t have to search.

On the other hand, following the news of a foreign country requires time and resources that individual investors do not always have. The mutual funds, however, should have enough resources, and therefore we assume that mutual funds do not face an asymmetric information problem.

Two principals are involved in mutual funds’ investment processes: managers, who run the funds, and individual investors, who hand over their hard-earned money for what they hope will be rewarding returns. And while we might assume intuitively that investors should distribute their wealth equally across domestic and foreign mutual funds, but we find that home bias persists.

Reinforcing Home Bias:

It begins with a home bias outlook in the individual investor’s access to information, follows its effect on investors’ judgment of a portfolio manager’s capabilities, and comes all the way around to reinforcing the home bias phenomenon itself.

They modeled a two-period economy, involving two hypothetical countries—one domestic, one foreign—and a continuum of investors. The domestic market represents any market one chooses to analyze. The foreign market, by contrast, represents any or all markets that are unfamiliar to domestic investors. For individual investors, the primary goal is to allocate their investments in the best
possible way. Thus, individual investors would like to understand the ability of mutual funds to generate abnormally good returns.

**Two main assumptions:**

(a) Individual investors know more about the domestic market than they do about foreign markets, while mutual funds are equally well informed about all markets;

(b) Mutual funds differ in ability to generate abnormal returns.

Thus, there is a hypothesis evaluated that investors who know more about the domestic market could make better evaluations of mutual funds investing in domestic markets than funds investing in foreign markets. These would make mutual funds investing in domestic markets more attractive to investors.

To evaluate managers’ abilities to generate abnormal returns, individual investors should look at funds’ past performance. Investors can easily identify strong funds among those that invest in the domestic economy: they perform much better than the economy.

It is much more difficult for investors to identify strong funds among foreign investments. Investors typically do not closely monitor the foreign economy and therefore cannot judge whether the performance of a foreign fund stems from its innate capabilities or from outside market forces.

Having less information about foreign markets, the investor’s ability to judge a manager’s capabilities is limited to comparing the results of this particular manager against the results of other managers. But investors independently learn the capabilities of domestic managers more quickly and easily than they learn the comparative abilities of managers in foreign markets. As a result, investors are able to allocate their domestic investment more efficiently, which makes that type of investment more attractive.

With investors able to allocate capital efficiently in domestic markets, home bias grows—along with the number of managers attracted to the domestic market.
and along with the diversity within the domestic market. Home bias not only persists, it is reinforced.

**Symmetric Information:**

The confirmation of home bias has broader implications. Mutual funds need not be asymmetrically informed for home bias to persist. More symmetric information at the level of the individual investor, however, could address some of the imbalance between foreign and domestic mutual fund investments. If individual investors had similar access to information about all markets, home bias would be diminished.

Yet mutual funds in the domestic market should, on average, be of higher quality and generate higher excess returns. But all things considered, it seems investors are likely to maintain a significant preference for the comforts of home even when surrounded by a world of information.

**Modeling Real Economies:**

There will be more investment in the domestic market than in the foreign market. “To check that point,” “one should assume reasonable values for the parameters of the model—such as discount factor or stock and asset volatility—and see what home bias; the model predicts for these parameters. There have been many studies that tried to estimate what the reasonable values for these parameters are, and over time a certain consensus was established. Using those values, we obtain that our model predicts home bias close to the actual one.”

After running 10,000 simulations, model showed that 73 percent of mutual fund investment was placed in domestic markets.

**Investing beyond your borders:**

One of the thorniest decisions investors have to make is whether to put money into foreign stocks. Investing in foreign companies can be lucrative, but the rewards come with additional risks, and spotting worthwhile investments overseas can take a tad more work than finding them at home.
**International opportunity:**

There are plenty of good reasons to invest abroad. International stocks represent added opportunity: U.S. stocks represent approximately 30% of the total value of global markets. In fact, most of the largest companies that make steel, electronics or consumer appliances are based outside of the United States, in countries such as Brazil and South Korea. There are well over a dozen major stock markets outside of the U.S. that have more than a thousand companies of substantial size. Many of those companies operate in rapidly growing economies with extraordinary rates of return.

From a portfolio management perspective, investing in foreign companies is a way to diversify. For instance, U.S. and foreign shares do not always move in sync. When one is up, the other may be down, and vice versa. In technical terms, such markets are said to lack correlation. A diversified portfolio balances uncorrelated assets to spread the risk.

Of course, that doesn't mean that U.S. and foreign shares always move in opposite directions. Many countries rely heavily on the U.S. for imports and exports, and can be susceptible to U.S. market shifts. In today's global economy, stocks often move in the same direction, especially when the U.S. is experiencing a big bear or bull market. Nevertheless, academic research shows that over the long term, U.S. and foreign shares are sufficiently independent so that investing overseas can smooth portfolio returns.

**Buying Overseas:**

For investors who have patience to do their research, international stocks can offer big rewards. The trick is to understand the opportunities as well as the risks. Here are some straightforward ways to buy into foreign companies:

**ADRs:**

While many investors appreciate the rationale for investing abroad, they may be deterred by the mechanics of purchasing shares on a foreign exchange. American depositary receipts (ADRs) can simplify the access of U.S. investors to foreign
markets. Listed on the New York Stock Exchange and Nasdaq, they can be traded, settled and held as if they were ordinary shares of U.S.-based companies. Foreign companies with ADRs issue financial reports that generally conform to U.S. accounting conventions and SEC rules. Companies with ADRs include Finland's Nokia, GlaxoSmithKline of the U.K. and Japan's Sony.

Although they trade on U.S. exchanges, ADRs still offer the potential benefits of diversification. Studies suggest that ADR prices tend to behave like the foreign stocks they represent.

**U.S. Traded International Stocks:**

There are a few foreign stocks that trade on U.S. markets. These stocks have met the listing requirements of either the New York Stock Exchange or Nasdaq.

**U.S. Multinationals:**

Before you jump into foreign stocks, it's worthwhile considering domestic stocks with exposure to foreign markets. Plenty of U.S. companies generate the bulk of their revenue from outside the U.S. Example: McDonald's, Coca-Cola and Gillette. More than half of their revenues come from overseas business. Buying shares of U.S. multinationals can be an effective way for investors to get exposure to the global economy.

However, investing abroad can also expose you to risks associated with exchange rates, political or economic instability, and differences in reporting and tax regulations. Still, in understanding these risks in relation to the potential rewards, investors have the opportunity to access foreign markets through instruments such as ADRs, international stocks traded on U.S. exchanges and U.S. multinationals.

**Broadening the Borders of Your Portfolio:**

One of the primary reasons for the popularity of international investing can be summed up in one word: diversification. Foreign markets provide access to a considerable number of investment opportunities, such as emerging markets and specialized regional economies. In fact, although the United States is the world's largest stock market, almost 50% of the world's stock market investing opportunities
are actually located outside of U.S. borders, according to the MSCI All Country World Index, a commonly cited measure of the world's stock market composition. To participate in the global marketplace, many investors look to mutual funds as the investment vehicle of choice. We can consolidate the major fund categories that exist for investors seeking international opportunities, as well as the advantages and disadvantages of these funds.

**Mutual Fund Varieties:**

There exist a wide variety of international investments through mutual funds. There are money market funds, funds that specialize in stocks, funds that specialize in bonds and funds that build portfolios using a combination of stocks and bonds. The major fund categories for investors seeking exposure to foreign markets include the following:

- **Global Funds:** Global funds seek opportunities worldwide, although many global fund managers invest the bulk of their assets in U.S. markets.
- **International Funds:** International funds invest strictly in non-U.S. markets. They achieve diversification by investing in both established markets and developing economies. Developing economies, popularly known as "emerging markets", can offer significantly greater growth opportunities than those available in established markets.
- **Regional Funds:** Regional funds focus on specific geographical regions, such as Europe or Asia. These funds achieve diversification by investing in multiple countries in a given region.
- **Country Funds:** Country funds concentrate on building a portfolio of securities issued by a single country. Germany, Japan and Mexico are each the focus of numerous country funds.

**Active and Passive Management:**

Whether an investor prefers an actively managed fund or one that's passively managed, he can find a fund with exposure to foreign markets that suits his style. Investors seeking active management often turn to mutual funds for the quality research that an experienced fund management team can provide when it comes to seeking opportunities in markets such as Turkey, China and Japan.
For passive investors, there is a wide variety of index funds from which to choose, including funds in each of the major categories, as well as a variety of funds that focus on specialty areas such as natural resources and socially-responsible investing.

**The Risk of International Investing:**

Investors, however, need to appreciate the serious risks involved with international stocks. For starters, there is exchange rate risk. A U.S. investor's return on a stock from a foreign country is tied to changes in the currency values between the U.S. dollar and that country's currency. If you buy a Japanese stock and the Japanese yen rises against the dollar between the time you buy and sell the stock, your return is worth more. On the other hand, if the yen weakens, your investment return weakens. Beyond upheavals in currency markets, there is country risk. Many countries suffer from political, social and economic instability, which makes investing in those places risky. If you think that investing in your home country is hard, spotting companies in foreign lands can be even tougher. Foreign governments have different reporting and tax regulations on securities. In many cases, foreign companies are not required to provide the same detailed information as U.S. companies must provide, and overseas companies may use different accounting procedures, which can make stock analysis trickier. Before putting money into an overseas stock, it's critical to get a good sense of its investment environment.

International mutual funds and domestic mutual funds share certain risks. Stock funds are subject to declining market values. Bond funds may be negatively affected by interest rate changes or by the inability of a creditor to repay a loan. Whether the fund in question is domestic or international, investors risk losing some or all of their initial investment.

However, investing in international securities carries an additional set of risks not usually seen in domestic investments. Investors need to be aware of the many issues that can have an impact on the value of their investments, including currency risk, political/economic/social risk, lack of market supervision and information, lack of liquidity, and higher costs.
**Currency Risk:**

Because foreign firms generally pay dividends and capital gains in their local currencies, currency risk is a primary concern. When a particular foreign currency is stronger than an investor's home currency, the investor benefits by receiving more of his or her home currency in return for each unit of foreign currency when a conversion is made.

The opposite is true when the home currency is stronger than a given foreign currency. A weak foreign currency reduces the amount of money investors receive when the foreign currency is converted. While a weak foreign currency is great news for travelers heading overseas, it can be of significant concern to from their home country position as an investor in overseas securities.

Given these realities, investor should consider the exchange rate outlook for his domestic currency and his host foreign country's currency before investing in a foreign mutual fund. If he makes a sizable investment in a foreign mutual fund and his domestic currency subsequently appreciates significantly against the foreign currency, even strong domestic returns of his foreign mutual fund can be eroded into mediocre gains or even losses once the effects of currency conversion are realized.

Some mutual funds hedge their foreign exchange risks, in which case both the potential risks and rewards from unhedged foreign currency risks are neutralized. Investors should be sure to understand a fund’s management position in this regard.

**Political/Economic/Social Risk:**

Many countries experience significant social and political upheaval. Military coups, war, civilian unrest, terrorist activity and other unexpected events can have negative consequences for investors. High returns will be of very little use to investor if a foreign government decides to impose new taxes on withdrawals of cash outside its borders, or worse, appropriates his previously successful corporation (and its profits) into the government's coffers.
Impact of Portfolio Management on the Investors’ Home

Regulatory Considerations:

Many foreign countries do not have the same supervision and control standards. Full financial disclosure and corporate governance vary greatly. This can make it difficult to obtain the type of information that is necessary to conduct a proper analysis of a firm, country or region's economic health. Even if adequate information can be obtained, it may prove costly and time consuming for fund managers to obtain it, and those information costs will eat into your returns at the end of the day.

Lack of Liquidity:

Not all foreign markets offer a highly-developed market place that enables nearly instantaneous trading of a large volume of individual securities. This can make it difficult to trade securities in a quick, convenient manner. As such, investor needs to consider his investment time horizon and the liquidity level of his chosen foreign market, and make sure there are no obvious potential conflicts between the two.

Higher Costs:

Investing in international markets can be more expensive due to a variety of taxes, transaction costs and commissions. As a result, mutual funds that invest in international markets tend to have higher expense ratios than similar domestic funds. Keep these costs in mind when considering international mutual funds, as their performance needs to compensate for their added expense if they are going to be of value to investor.

The appeal of Mutual Funds:

Mutual funds are a convenient way to invest in international markets. Investing in international funds adds diversification to investor’s portfolio, provides an opportunity to participate in the growth opportunities in foreign markets, and delegates responsibility for addressing most of the risks to professional money managers.
With an actively managed mutual fund, money managers and analysts conduct research on potential holdings. In an index fund, the managers and analysts monitor the benchmark index and adjust the holdings of their portfolios to make sure they match the index as companies are added and removed from the benchmark. In either case, investors have no need to concern himself with tasks such as tracking down information about foreign companies, making trades or converting currency.

In an actively managed portfolio, the money manager will also bear the burden of worrying about the political, economic and social risks. Furthermore, investors don’t need to be concerned about liquidity risk because the mutual fund company will redeem their shares, with no need for them to find a buyer on the open market. Although it's true that each of the risks we've discussed may still have an impact on the value of investor’s portfolio, the day-to-day task of trying to mitigate the risks can be delegated to the experts.

*International Funds and Investors’ Portfolio:*

While international funds do have their risks, they also offer the potential for significant rewards. Emerging markets often deliver double- and triple-digit returns, with countries such as Pakistan, Columbia and Egypt posting extraordinary returns in recent years. At the macro level, over the 30-year period from June of 1976 to June of 2005, rolling 12-month returns for the MSCI World-ex U.S. Index have bested the Wilshire 5000 16 out of 30 times. That level of success makes international investing quite attractive.

On the risk side of the equation, professional financial advisors rarely recommend that international investments account for more than a minority share of an investor's portfolio. Proper planning and prudent fund selection can help to mitigate risks. Investors often overlook the fact that their domestic funds may well have a significant percentage of their portfolios invested in foreign securities. These positions should be checked on before investor load up on additional foreign exposure through international funds.
Overall, adding international investments to domestic portfolio may significantly increase its performance with a minimal increase in overall risk, just as adding an appropriate mix of stocks to a fixed-income portfolio can boost the upside potential without adding significant risk. So investor can consider venturing past domestic economy's frontiers as a way to expand his portfolio's efficient frontier.

**Mutual fund flows and expected Stock Returns:**

The performance evaluation of Indian mutual funds is carried out through relative performance index, risk-return analysis, Treynor's ratio, Sharp's ratio, Sharp's measure, Jensen's measure, and Fama's measure. The data used is daily closing NAVs. The source of data is website of Association of Mutual Funds in India (AMFI). The study period is 2009 to 2011. The results of performance measures suggest that most of the mutual fund have given positive return during 2009 to 2011.

Top five asset management companies is selected as per AUM as on 30th September 2011. The sample AMCs are HDFC, ICICI Pru. Life, Reliance, UTI and Birla sun life. Five equity diversified mutual fund schemes each from selected AMCs is selected randomly. Daily data about the closing Net Asset Value of the selected schemes has collected from the websites www.Amfiindia.com and www.Mutualfundsindia.com. The most popular and widely tracked BSE SENSEX is used as a proxy for the market. The daily closing value of BSE SENSEX is collected from the website www.bseindia.com. The reference period for the data is taken from 2009 to 2011. The yield to maturity of 364 days treasury bills is taken as risk free rate of return. The data for that is collected from the official website of Reserve Bank of India. Microsoft Excel is used for all the calculations.
Data analysis:

Returns on selected schemes of selected companies

<table>
<thead>
<tr>
<th>Return on selected schemes</th>
<th>Average annual return</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>HDFC</strong></td>
<td>2011</td>
</tr>
<tr>
<td>HDFC Capital Builder Fund</td>
<td>-26.9715</td>
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<td>HDFC Core &amp; Satellite Fund</td>
<td>-30.0512</td>
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<tr>
<td>HDFC Equity Fund</td>
<td>-31.0903</td>
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<tr>
<td>HDFC Long Term Equity Fund</td>
<td>-25.9228</td>
</tr>
<tr>
<td>HDFC Top 200 Fund</td>
<td>-27.8342</td>
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<tr>
<td><strong>Average</strong></td>
<td>-28.3740</td>
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<tr>
<td><strong>ICICI PRUDENTIAL</strong></td>
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<tr>
<td>ICICI Prudential Discovery Fund – IP</td>
<td>-27.0940</td>
</tr>
<tr>
<td>ICICI Prudential Service Industries Fund</td>
<td>-28.1453</td>
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<tr>
<td>ICICI Prudential Top 100 Fund</td>
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<tr>
<td>ICICI Prudential Top 200 Fund</td>
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<td><strong>Average</strong></td>
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<tr>
<td><strong>RELIANCE</strong></td>
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<tr>
<td>Reliance Growth</td>
<td>-32.0251</td>
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<tr>
<td>Reliance NRI Equity Fund</td>
<td>-28.0870</td>
</tr>
<tr>
<td>Reliance Regular Savings Fund - Equity</td>
<td>-35.6433</td>
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<tr>
<td>Reliance Short Term Equity Fund</td>
<td>7.5988</td>
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<tr>
<td>Reliance Vision</td>
<td>-33.6102</td>
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<td><strong>Average</strong></td>
<td>-24.3534</td>
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<tr>
<td><strong>UTI</strong></td>
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<tr>
<td>UTI Equity Fund</td>
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<tr>
<td>UTI Master Value Fund</td>
<td>-28.9865</td>
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<tr>
<td>UTI Mid Cap Fund</td>
<td>-27.3370</td>
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<tr>
<td>UTI Opportunities Fund</td>
<td>-12.9068</td>
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<tr>
<td>UTI Equity Fund</td>
<td>-17.6283</td>
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<tr>
<td><strong>Average</strong></td>
<td>-21.6091</td>
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<tr>
<td><strong>BIRLA SUN LIFE</strong></td>
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<tr>
<td>Birla Sun Life Advantage Fund</td>
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<tr>
<td>Birla Sun Life Dividend Yield Plus</td>
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<td>Birla Sun Life Equity Fund</td>
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<td>Birla Sun Life Mid Cap Fund - Plan A</td>
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<td>Birla Sun Life Top 100 Fund</td>
<td>-23.2216</td>
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<tr>
<td><strong>Average</strong></td>
<td>-26.7054</td>
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</tbody>
</table>

Source: calculated data
Inference:

The above table depicts the performance of selected equity diversified schemes return for a period of 2009 to 2011. The data shows the schemes-wise return for three years in which HDFC Top 200 Fund-Growth scheme of HDFC Company is performing well. Reliance regular saving equity– Growth gives highest return of 97.8366 in the year 2010. In year 2009, all schemes outperformed compare to other years except UTI Equity Fund - Growth. In year 2011, the performance of all the all schemes was found to be poor with the exception of Reliance Short Term Equity Fund - Growth. In all three years duration HDFC Top 200 Fund-Growth has performed well compare to others schemes.

Mutual funds that have fared well in different time spans:

One of the simplest ways of selecting mutual funds is by looking at their historical performances and picking the top performers. While it is easy to come across fund listings that represent best performers, these are based on a single time scale. So, a listing may show top performing funds on the basis of 3-year or 5-year returns. A fund can be a top performer on one time scale, but may be an underperformer in another.

Take the DSPBR India T.I.G.E.R Fund, which has outperformed its benchmark on a 5-year scale, but has fared worse than its benchmark on the 3-year scale. In three years, the fund returned 6.34% on an average, compared with its benchmark BSE-100, which delivered 7.89%. On the other hand, the fund delivered 8% annualised returns over a 5-year period, in comparison to its benchmark that delivered 7.73% returns. This implies that a person who had invested in 2006 would be better off than a person who had invested in 2008.

Now, let us consider the Taurus Infrastructure Fund, which has lost 25% in the past year in comparison to its benchmark BSE-200, which lost 15.08%, thereby underperforming its benchmark on the one-year scale significantly. However, the same fund is an outperformer on a 3-year scale, delivering 9.9% annualized return in comparison to its benchmark, which gave 8.32%.
Therefore, the listings for top performing funds that are based on single time scales may not represent true outperformers. Instead, an analysis based on multiple time scales may prove useful for the investors who strongly rely on historical performance. I have tried to zero in on funds that have given better results than their benchmarks and category averages consistently across different time scales.

Outperformance would imply either gaining more than the benchmarks and category averages or losing less than the benchmarks and category averages. I have considered six time scales, ranging from three months to five years. The performances of these funds were compared with their benchmarks and category averages across these time scales. Though the time frames of three months and six months are too short for evaluating equity mutual funds, such scales are considered to check the funds' short-term consistency.

An analysis of as many as 349 equity mutual funds schemes with growth options has been done. All equity schemes are included in the analysis, and include diversified, tax plans, sector funds, dividend yield funds, contra funds, mid-cap and small-cap funds. I have considered only mid- to large-sized funds and ignored the smaller ones. The equity funds whose latest available corpus was more than Rs 100 crore were included. The inference was that 14 funds were consistent in their performance.

**Funds that have beaten their benchmarks over different time periods:**

Of the 349 equity mutual funds analyzed, 14 turned out to be consistent outperformers over six time scales, ranging from three months to five years.

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Corpus (in crore)</th>
<th>3-month</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
<th>6-month</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
<th>1-year</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
<th>2-years</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
<th>3-years</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
<th>5-years</th>
<th>Benchmark</th>
<th>Fund Benchmark</th>
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<tr>
<td>IIFL-Bluechip</td>
<td>1,902.33 BSE Sensex</td>
<td>258.9</td>
<td>5.88</td>
<td>-0.21</td>
<td>-0.76</td>
<td>-7.85</td>
<td>15.51</td>
<td>7.39</td>
<td>11.99</td>
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<td>IIFL-Intra</td>
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<td>HDFC-India Equity</td>
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<td>ICICI-Select Midcap</td>
<td>2,166.34 BSE MidCap</td>
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<td>ICICI-Midcap</td>
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<td>ICICI-Smallcap</td>
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<td>5.40</td>
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<td>ICICI-Opportunities</td>
<td>1,757.92 BSE Sensex</td>
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</table>

Data as on 16 Sept 2011.
Returns greater than one year are annualised.
Only growth option schemes and funds with corpus of more than Rs 100 crore are considered for the analysis. Latest available.
Data source: NAVIndia
These 14 mid- to large-sized funds have outperformed their benchmarks and category averages in 3 months, 6 months, 1 year, 2 years, 3 years and 5 years. One would have fared well irrespective of the time scale in which the investment was made and, hence, these funds are true outperformers. In this list, UTI AMC tops with its five funds. Franklin AMC shares the second spot with three funds, while BNP Paribas BSE 1.30%, Canara Robeco, IDFC, SBI, Tata and Sundaram AMCs have one fund each.