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Music themes are good but thematic funds may prove injurious to investors

Devina Mehra | 23 Oct 2024

An asset management cmpany cannot have multiple small-cap schemes or multiple mid-cap schemes.

SUMMARY

We've seen a surge in new fund offers focused on investment themes. But it's best to steer clear of funds that may have been launched for the benefit of fund houses more than investors. These often come too late and lock people in sub-optimal asset allocations.

What do you think when you see a slew of new fund offers (NFOs) from various mutual funds or portfolio management services (PMS) providers centred around a particular theme? Over the past year, these have been mostly in areas like small caps, public sector undertakings, industrials, defence, green energy, etc.

Most investors think it means these fund managers believe that the theme will give superior returns. Their enthusiasm shows up in data from the Securities and Exchange Board of India (Sebi): In 2024-25, 47.3% of net inflows into equity mutual funds have gone to sectoral/thematic funds.

Small-cap funds have seen inflows of another 7.6%. All else, including large cap, multi cap, flexi cap, mid cap, etc, make up only 45%.

How skewed this is can be seen from the fact that thematic funds made up only 12.5% of the assets under management for equity mutual funds at the beginning of the year. The theme this year has clearly been thematic funds.

In the past too, we have seen a clustering of schemes around a particular theme. In 2021, for example, there were many Nasdaq or China/Greater China funds launched. All of them crashed the following year, with the Nasdaq being among the world's worst performing indexes in 2022.

This is a theme (pun intended) you would see play out every time NFOs cluster around a particular category, be it defined by geography, sector or size (small cap versus large cap). Usually, investors lose money or underperform on such investments.

The data is simple and clear. Most thematic schemes come around the end of the bull run for that theme.

But then, why do fund houses launch funds for themes that have already largely run their course? Don't they understand that risks are high and super-normal returns are unlikely?

Of course they do. But they also understand that you, as a retail investor, have come to understand that theme only by this point in time. Maybe you even have some 'FOMO' (fear of missing out).

Hence, when the scheme is launched, you're likely to participate enthusiastically, even if it eventually won't end well. In short, these schemes are launched because they can gather assets for the fund house rather than optimize portfolio returns for you.

I remember an asset management company (AMC) CEO being asked on a panel how he felt when its fund, investing in a narrow list of global tech stocks and launched in 2021, was down 37% in a year. The CEO replied that he felt nothing, as he was only offering a product and it was up to the investor to decide whether to invest in it.

AMCs also launch these schemes because Sebi regulations do not allow multiple schemes from a particular AMC on the same theme. Thus, an AMC cannot have multiple small-cap schemes or multiple mid-cap schemes. But nobody stops AMCs from launching funds on 'new' themes.

For one, the NFO gets investor interest and investments. For another, Sebi regulations cap the total expense ratio of a mutual fund scheme by the size of its corpus. As the older schemes of an AMC become larger, the percentage chargeable as expenses reduce. The way around it is to have some smaller-sized funds, and NFOs achieve this.

Plus, one should check if the name of a scheme is a good descriptor at all of what it actually holds. We find that value funds apply for overpriced initial public offerings (IPOs) and small-cap funds hold 10% in Reliance, which is the largest market-cap company in India.

Many fund houses apply under very different schemes for the same IPO. One applied under its large, mid and small cap schemes as well as a tax saver scheme. Another fund applied for a loss-making company's IPO both from its retirement and value schemes.

It was the same during the 2021 IPO boom, when even value funds were applying for so-called 'New Age' tech firms, which might have fit the criteria for a different sort of fund but definitely can't be classified as value buys.

I've even seen green energy/ESG funds holding coal and oil stocks. This is a further indication that most fund houses bring out NFOs or thematic funds just to gather assets.

The poor timing of most thematic NFOs is one issue. The other part that I have spoken often enough about is that asset allocation determines 85-90% of your returns. By investing in a thematic fund, you are getting locked into its asset/sector allocation.

In addition, you are the one deciding when to invest in a particular industry or theme. Now that's something that determines most of your returns, and, therefore, if you are getting professional help from a fund manager or financial advisor, the key input they must provide is how to do tactical and dynamic asset/sector allocations. If they leave that decision to you, then what are you paying them for?

Therefore, find a fund manager or an investment advisor who dynamically manages this allocation for you across asset classes, within equities or across geographies and sectors—because that will determine most of your returns.

A tip from me: steer clear of thematic funds, at least the new ones. They are almost always injurious for the health of your portfolio.

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