What happens when you jump from mutual funds to direct equity

ET CONTRIBUTORS • Last Updated: Sep 23, 2020, 02:10 PM IST

Synopsis
Despite having the power of choice, investors are often unable to create optimal portfolios as they get influenced by the 'bling' of certain investments and end up making decisions that might not align with their risk-return requirements.

Mutual funds understand the distinction between trading and investing. Frequent buying and selling can sometimes seem like a great way to generate returns.

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By Yogesh Sharma

Investors today are spoilt for choice when it comes to picking **optimal investment instruments** for their portfolios. These options are available across the risk-return spectrum, enabling one to create diversified portfolios. However, despite having the power of choice, investors are often unable to create optimal **portfolios** as they get influenced by the 'bling' of certain investments and end up making decisions that might not align with their risk-return requirements.

A classic example is the face-off between direct equities and mutual funds. Investing in direct equities can be appealing due to the allure of the **equity market**, and the promise of sharp and quick returns. On the other hand, **mutual fund** investments may seem a bit 'plain jane' since one just buys the units and sits tight. The price of the mutual fund investment does not fluctuate minute by minute, like the stock price and it might seem nothing much is really happening.

However, that is not entirely true.

The mutual fund machinery
As an investor, when you choose to invest in a mutual fund scheme, you are not simply investing in a single stock but in an entire portfolio of stocks. The principles that guide the buying and selling of these stocks and the overall portfolio composition are clearly articulated under '**investment strategy**' in the scheme information document (SID) of that particular scheme. Fund managers follow this strategy judiciously to ensure that investors get the desired risk exposure and can potentially meet their return requirements.

Generally, a mutual fund scheme is managed by a fund manager, who is supported by a team of research analysts. These analysts conduct in-depth stock analysis and recommend stocks for portfolio inclusion, usually based on proprietary valuations models. The fund manager periodically reviews these recommendations and takes the final decision on their inclusion in the portfolio. This way, the entire stock selection process becomes highly robust and selective.

The CIO oversees the fund management of multiple schemes to ensure overall adherence to established research quality and ethical standards. Just like the buying decision is tethered to a sound investment strategy, so is the selling decision.

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Instead of reacting to the market frenzy or succumbing to behavioural biases, fund managers usually exit a stock if either its value has been completely realised or there is a fundamental change in the company that negates the initial investment rationale. This way, an investor is assured that multiple people work behind the screen to ensure that value accretive stocks are included in a particular mutual fund scheme and portfolio decisions are systematic and robust.

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Mutual funds understand the distinction between trading and investing. Frequent buying and selling can sometimes seem like a great way to generate returns.

However, as most wise investors will tell you, it is near impossible to time the market. As a result, most investors who tend to frequently trade, end up selling in panic near the bottom and buying into the euphoria at the top. They incur significant transaction costs that can reduce their profits (if any). Mutual fund managers, on the other hand, follow a long-term approach to investing. This entails investing in fundamentally strong companies that can, over a period of time, generate good returns.

In the short term, stock prices are influenced by a host of market factors. As a result, in the short-term stock performance tends to be highly volatile. There will be short periods of time when stock prices witnessed continued gains while there will also be intermittent periods when prices witness continued losses.

In both cases, mutual fund schemes would assess the source of price movement and take a decision only if the factor has a long-term impact on the stock. Since mutual funds have a long-term approach to investing, certain mutual fund schemes might underperform the broader market in the short term or in certain time periods. Further, it is important to understand that mutual fund schemes are basically diversified portfolios that comprise a mix of stocks.

Due to their diversified nature, it is unlikely that sharp movements in any one stock would have a big impact on overall portfolio returns. This can be highly beneficial to an investor as it can ensure that one single stock does not have an inordinately large impact on his portfolio.

At the end of the day, all investments – whether equity mutual funds, fixed income mutual funds or direct equity – must be considered from an overall portfolio perspective, i.e., their inclusion in your portfolio should meet your asset allocation strategy. The key to generating long-term wealth is to build a robust and well-diversified portfolio that is firmly tethered to your risk-return requirements.

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