An Investor Education Initiative

POTENTIAL WEALTH CREATION THROUGH EQUITY

Topic 1: Equity as an asset class has the potential for wealth creation in the long term

We make investments with the expectation of future cash flows either as capital appreciation or income. Assets are economic resources which generate cash-flow. For individual investors, there are four major asset classes:-

Equity - Shares of companies which are traded on stock exchanges and other related securities (e.g. derivatives) that derives its values from the underlying shares.

Fixed Income - Assets which give periodic interest payments and returns the principal on maturity of the asset. Fixed income assets can be market linked or non-market linked.

Commodity - Raw materials which are used to make products which have economic value. For individual investors, gold is the most popular commodity.

Real Estate - Residential or commercial for rental income or capital appreciation.

Assets can be financial or physical. Equity and fixed income are financial assets. Gold can be purchased both in physical form (e.g. gold jewellery, bars, coins etc) or financial form (ETFs, gold funds). Real estate investments for individual investors are usually in physical assets.

While the main objective of investing in an asset is to get **returns** (capital appreciation or income), two important factors should always be considered - **liquidity** and **transparency**. One of the biggest advantages of financial assets over physical assets is liquidity.

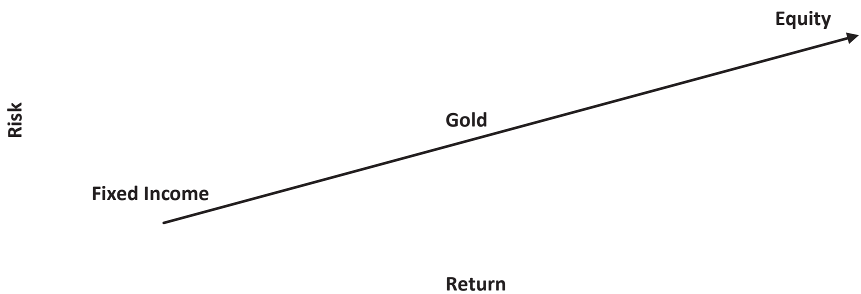
For example, you can sell shares of companies or units of open ended mutual funds on any business day, but the sale of property may take several months or even years to materialize. The other main advantage of financial asset over physical assets is transparency. Financial markets are regulated and asset prices are transparent but in absence of a regulated secondary market, physical assets lack transparency in prices.

Let us now discuss the two fundamental characteristics of asset classes – **risk** and **return**.

Risk and Returns

The relationship between risk and return is fundamental in investments - **higher the risk, higher the expected returns**. Different asset classes have different risk profiles.

Risk/Return profile of different asset classes

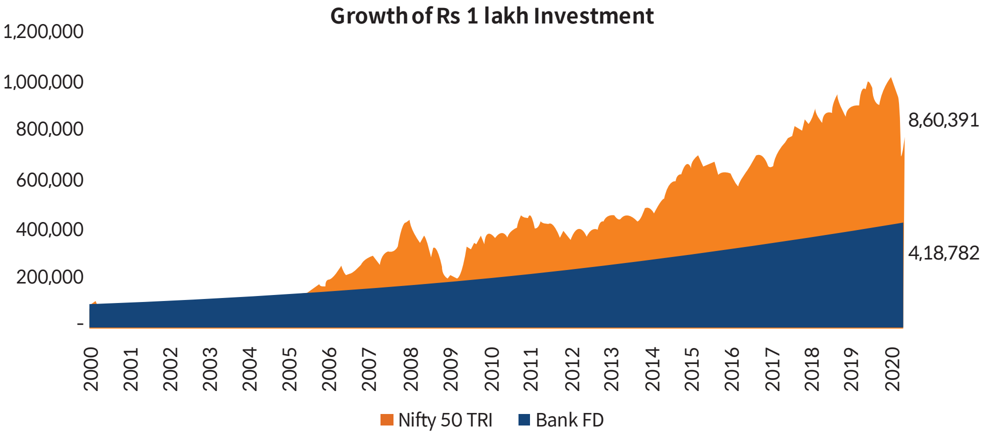


Equity has the highest risk but also the highest return potential among all asset classes. We will compare the historical performance of equity versus other asset classes.

Equity versus Fixed income

Fixed income is the most popular financial asset of most Indian households. Household Savings is mainly invested in traditional fixed income investments like Bank Fixed Deposits (FDs), Government Small Savings Schemes etc.

Equity has greater wealth creation potential over long investment horizons. The chart below shows the growth of Rs 100,000 investment in Nifty 50 (the index of 50 largest stocks by market capitalization) and Bank Fixed Deposits over the last 20 years (from 1st January 2000 to 30th June 2020).



Source: National Stock Exchange, Advisorkhoj Research (1st Jan 2000 to 30th Jun 2020).

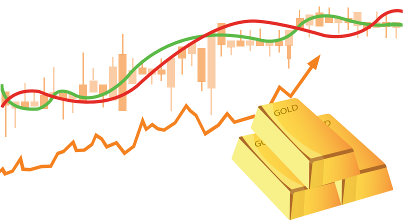
You can see in the chart that the Nifty 50 despite several deep corrections in prices e.g. 2000-01, 2008, 2011, 2015-16, created much more wealth than fixed deposits. Over the last 20 years or so (from 1st January 2000 to 30th June 2020), your Rs 1 lakh investment in Nifty 50 TRI would have grown to Rs 8.60 lakhs at a Compounded Annual Growth Rate (CAGR) of 11.07%. Your investment in FD would have grown to only Rs 4.18 lakhs at an annualized rate of 7.23%.

Source: National Stock Exchange, Advisorkhoj Research (1stJan 2000 to 30th Jun 2020).
Past performance may or may not be sustained in future.

Equity prices in the short term depend on demand and supply of stocks in the market, but in the long term are driven by fundamental factors like overall economic growth, inflation, industry growth, market share, how efficiently management uses capital etc. Fixed income returns on the other hand, are largely dependent on prevailing interest rates. In an inflationary environment, fixed income returns struggle to beat inflation whereas equity aims to give superior inflation adjusted returns in the long term.

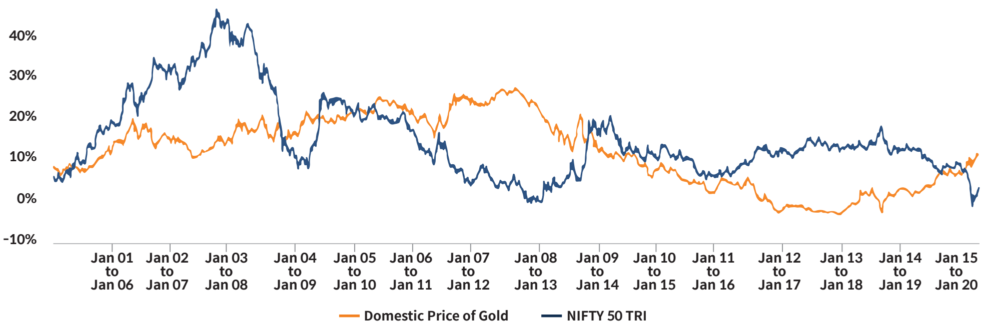
Equity versus Gold

Gold in physical form, especially jewellery is a popular investment in many Indian households due to the cultural significance of the precious metal in our society. Physical gold, especially as jewellery however, has several drawbacks like impurity, risk of theft, storage costs etc. Gold in form of financial asset e.g. Gold ETFs, Gold funds etc. has more economic value than physical gold as an investment gold is used for risk diversification and hedge against inflation in the long term.



Equity and gold price movements usually have a negative correlation, i.e. gold underperforms in equity bull market and outperforms in bear market. To compare gold and equity performance in different market conditions, we looked at 5 year rolling returns of Nifty 50 TRI versus Gold (see chart below) over the last 20 years. You can see that over 5 year investment periods across different market conditions, Nifty outperformed gold most of the time.

5 year rolling returns



Source: Advisorkhoj Research (1st Jan 2000 to 30th Jun 2020).
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Taxation of equity versus other asset classes

Taxation of proceeds from sale of assets should be one of the most important considerations in making informed investment decisions. In India, equity as an asset class is one of the most tax efficient investment options. Interest paid by Bank FDs and most Government Small Savings Schemes is taxable as per income tax rate of the investors. Short term capital gains (investments held for less than 3 years) arising out of sale from debt mutual funds, gold and real estate are also taxed as per the income tax slab rate of the investors. Long term capital gains (investments held for more than 3 years) arising out of sale from debt mutual funds, gold and real estate (immovable properties held for more than 2 years) are taxed at 20% after allowing indexation benefits.

Short term capital gains (investments held for less than 1 year) arising out of sale from equity shares, units of equity or equity oriented mutual funds are taxed at 15%. Long term capital gains (investments held for more than 1 year) arising out of sale from equity shares, units of equity or equity oriented mutual funds of up to Rs 1 lakh are tax exempt. Long term capital gains arising out of sale from equity shares, units of equity or equity oriented mutual funds in excess of Rs 1 lakh is taxed at 10%. For investors in the higher brackets, equity is a much more tax efficient compared to other asset classes.

Topic 2: Why Equity Mutual Funds?

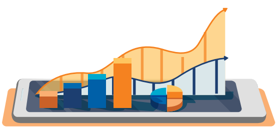
Investors have realized that equity mutual funds are one of the good investment options which aim for long term wealth creation. The benefits of investing in equity mutual funds are as follows:-

- Equity mutual funds provide risk diversification by investing in a portfolio of stocks across different industry sector. By diversifying across stocks and sectors, mutual fund schemes aim to reduce stock and sector specific risks to a large extent.

- Mutual funds work by pooling money from a large number of investors making them one of the ideal products for small investors. The minimum investment in mutual funds can be as low as Rs 5,000. If you are investing through a Systematic Investment Plan (SIP), then you can start with instalments of just Rs 1,000 or Rs 500, in case of ELSS mutual funds.

- Mutual fund schemes are managed by professional fund managers who have experience and expertise of investing in stock markets. Fund managers are tasked with outperforming the market benchmarks and generate superior returns for investors.

- Open ended mutual fund schemes (with the exception of Equity Linked Savings Schemes) offer high liquidity. You can redeem units of open ended schemes partially or fully at any time by sending redemption request to the Asset Management Company (AMC). Investors should note that redemptions in the exit load period may attract charges.



- Mutual funds are highly transparent investments. AMCs disclose the underlying securities of mutual fund scheme and various performance related metrics in their monthly factsheets.

- Mutual funds are regulated by Securities Exchange Board of India (SEBI) whose primarily role is to protect interest of investors. SEBI's oversight make mutual funds relatively safer compared to other investment options which may not have regulatory oversight.

- Equity mutual funds are one of the most tax efficient investment options. We will discuss tax advantages of equity funds later in this article.

Mutual Fund outperformance

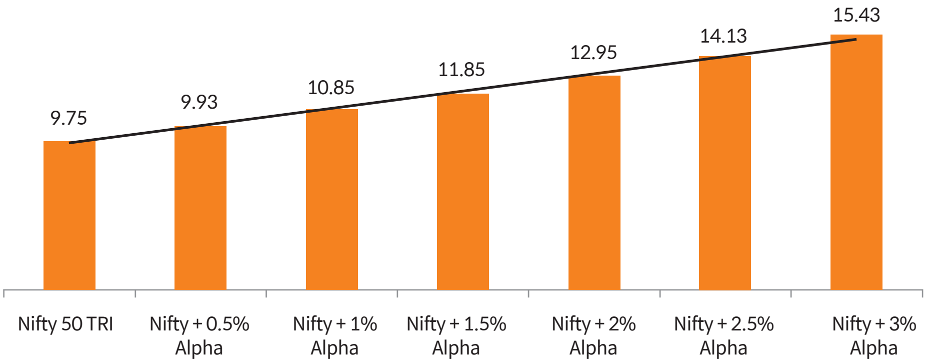
As mentioned earlier, mutual funds aim to outperform the market index and generate superior returns for investors over sufficiently long investment horizons. Experienced fund managers have the ability the identify stocks with higher earnings growth potential or stocks which are available at a discount to their intrinsic value or stocks with high earnings growth potential trading at a reasonable price.

In addition to superior stock selection, fund managers can also be overweight/underweight in certain industry sectors relative to the market index based on their outlook for different sectors. By being overweight on sectors which have higher growth potential, fund managers can outperform the market. From time to time fund managers also book profits in stocks which they think have become expensive. These profits can be distributed to investors as dividends (in dividend options) or re-invested in the scheme (in growth option).

Summary

In the last 20 years (1st May 2000 to 30th June 2020) Rs 1 lakh invested in Nifty 50 TRI would have grown to Rs 9.75 lakhs. The chart below shows the extra wealth creation for every additional 50 bps of alpha.

Growth of Rs. 1 lakh investment over 20 years (Rs. lakhs)



Source: Advisorkhoj Research.
Past performance may or may not be sustained in future.

Historical performance of top performing equity mutual funds across different category has shown consistent alpha creation over long investment horizons. In addition to wealth creation potential, equity mutual funds are also one of the most tax efficient investment options. You should review your investments and see if you have adequate investments in equity funds to meet your long term financial goals.

Source: Advisorkhoj Research.

Topic 3: Factors to consider when investing in Equity Mutual Funds

Mutual funds are increasingly becoming the preferred options for Indian households to invest their savings to beat inflation and create wealth. As per AMFI, total equity funds (including ELSS) AUM in March 2000 was around Rs 34,000 crores. As on 30th June 2020, equity funds AUM stood at Rs 650,000 crores, growing at a CAGR of 16% over the last 20 years.

Source : Advisorkhoj Research.

If you align your investments with your financial goals, you have a much higher potential for achieving success in your goals.

The following factors should be considered while making investments in equity funds:

What is your investment goal?

What is your investment horizon?

What is your risk appetite?

Investment goal

Your investment goals can be retirement planning, children's higher education, children's marriage, making down payment for home purchase, planning for a foreign vacation etc. Most investors will have multiple goals. There are several benefits for associating investments with your financial goals.

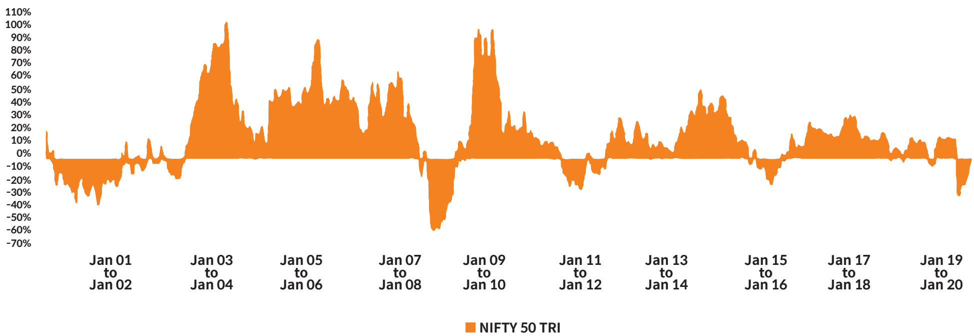
- Since we have an emotional attachment with many of these goals, we stay committed to our investment plan which helps us in the long run.
- A clearly defined goal (in quantitative terms) will help you estimate how much you need to save and invest for that goal.
- Associating investments with goals can help you make the right investment decisions, e.g. investment in fixed income for short term goals, investment into equity for long term goals etc.

Investment time horizon

One of the most important aspects of goal planning is defining goal timelines. If your investment goal is retirement planning, if you assume your retirement age to be 60 years and you are 35 years old, then your time horizon is 25 years. Knowing your investment horizon helps you invest in the right asset class. If you have a long investment horizon, then short term volatility has very little impact on the absolute returns over your investment horizon. Equity can be an ideal asset class for your long-term goals. Even though equity is volatile and can correct in value from time to time, it may eventually recover and grow in value giving you potential capital appreciation.

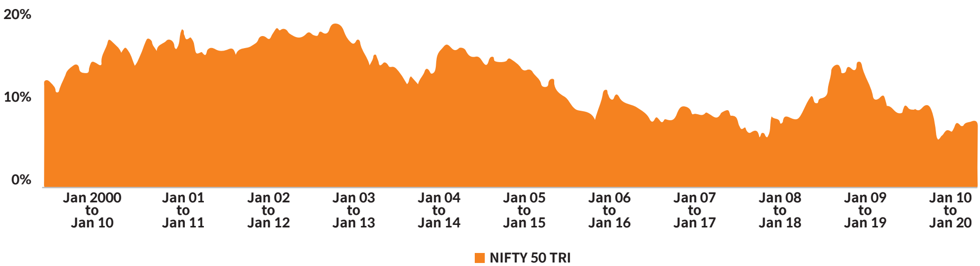
Volatility reduces over longer investment horizon

The chart below shows the 1 year rolling returns of Nifty 50 TRI since 1st July 1999 to 30th June 2020



Source: Advisorkhoj Research
Past performance may or may not be sustained in future.

Now, if you compare the 1 year rolling returns with 10 year rolling returns, you can see that 10 year rolling returns are even less volatile. That is why equity funds are one of the good asset classes for your long term investment goals.



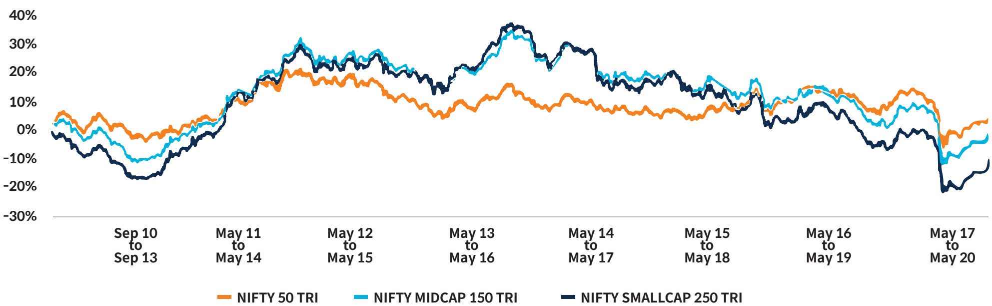
Source: Advisorkhoj Research
Past performance may or may not be sustained in future.

Risk appetite and volatility

There are two aspects of risk appetites - your risk capacity and your risk tolerance. Risk capacity is your actual capacity to take risk depending on your investment horizon and age among other factors. Your risk capacity is higher for long investment horizons because your investments have enough time to recover from short term volatility. Similarly, risk capacity depends on your age. You can take more risks when you are younger because you have a long working life ahead of you during which you can save and invest. Risk capacity declines with age. Among other factors, financial situation of the investor, particularly financial liabilities influence risk capacity.

Risk tolerance is a person's attitude or preference towards risk. Some investors are inherently more risk averse than others irrespective of their age/stage of life and financial situation. Risk tolerance also depends on the investment experience of investors e.g. new investors will have less risk tolerance than experienced investors who may have experienced multiple investment cycles (bull and bear market cycles).

Your risk appetite will be a combination of your risk capacity and risk tolerance. You should take both into consideration when making investment decisions. Some categories of equity funds are more volatile than others, e.g. small cap funds are more volatile than midcap and large cap funds. The chart below shows the 3 year rolling returns of Nifty 50 TRI (large cap), Nifty Midcap 150 TRI (mid cap) and Nifty Small Cap 250 TRI (small cap) since 1st January 2010.



Source: Advisorkhoj Research
Past performance may or may not be sustained in future.

The chart above clearly shows the relative risk profiles of large cap, midcap and small cap market segments - small cap being the riskiest and large cap being the least risky. The chart also reinforces the relationship between risk and return, i.e. higher the risk, higher the potential returns.

You should factor in both risk and returns potential when selecting equity funds and ensure that you are investing according to your risk appetite. If you have higher risk appetite, you can have larger allocations to midcap and small cap funds. However, if you do not have sufficiently high risk appetite, your mutual fund portfolio should be predominantly large cap oriented.

Summary

You should have a diversified portfolio of mutual funds comprising of different asset classes e.g. fixed income, equity etc and different types of funds e.g. large cap, midcap, multicap, etc. Though there are some thumb rules which suggest 70 - 80% of your equity portfolio to be in large cap funds and the 20 - 30% in mid and small cap, you should develop your own investment plan based on your investment goals, risk appetite and liquidity needs.

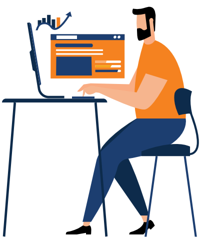
It is always advisable to engage with a financial advisor who can help you define your financial goals, understand your risk appetite and help you with selection of the right mutual fund schemes. Your advisor should also help you monitor your investment portfolio to ensure that you are on track of your investment goals.

Topic 4: Types of Equity Mutual Funds

Equity funds invest in shares of companies and other related securities. While all equity and equity related securities are subject to market risks, different types of equity securities have different risk profiles. One major risk characteristic of equity is based on the size of the company or market capitalization. Market capitalization of a company is the market price of the shares multiplied by number of shares outstanding. SEBI has classified stocks into three market cap segments:-

Large Cap: Top 100 stocks by market capitalization are large cap stocks. These companies are characterized by large size, market leadership in their respective industry sectors, greater financial strength and wide public ownership. Large cap stocks are perceived by investors to be less risky and therefore, command higher valuations.

Midcap: 101st to 250th stocks by market capitalization are midcap stocks. These companies are generally younger and smaller in the size compared to large cap companies. The percentage of free float shares (shares held by public) in midcap is lesser than large cap stocks. Midcap stocks are perceived to be riskier than large cap stocks and therefore, trade at lower valuations compared to large cap stocks. However, midcap stocks have higher earnings growth potential than large cap stocks. Midcap stocks, in future can become large cap stocks and therefore, see valuation re-rating. While midcap stocks have the potential of giving higher returns than large cap stocks in the long term, they tend to be more volatile than large cap stocks in the short term.



Small Cap: 251st and smaller stocks by market capitalization are small cap stocks. Small cap stocks are perceived to be riskier than large cap and midcap stocks, but they have higher returns potential than midcap and large cap stocks in the long term. Small cap stocks can be extremely volatile in the short term. Small cap companies in India are mostly owned by promoter or promoter families and the percentage of free floating shares in small cap is much less than midcap and large cap stocks. In extreme market conditions, small cap stocks can have much less liquidity compared to midcap and large cap stocks.

Equity funds classification according to market cap mix

Large Cap Funds: As per SEBI's mandate, large cap funds must invest at least 80% of their assets in large cap stocks. The balance can be invested in midcap, small cap and other assets. These funds invest across industry sectors to diversify risks.

Midcap Funds: As per SEBI's mandate, midcap funds must invest at least 65% of their assets in midcap stocks. The balance can be invested in large cap, small cap and other assets. These funds invest across industry sectors to diversify risks.

Small Cap Funds: As per SEBI's mandate, small cap funds must invest at least 65% of their assets in small cap stocks. The balance can be invested in large cap, midcap and other assets. These funds invest across industry sectors to diversify risks.

Large Cap and Midcap Funds: As per SEBI's mandate, these funds must invest at least 35% and maximum 65% of their assets in large cap funds and at least 35% and maximum 65% their assets in midcap funds. The balance assets can be invested in stocks of any market cap segment and other assets. These funds invest across industry sectors to diversify risks.

Multi Cap Funds: The asset allocation of multi cap funds shall be minimum 75% in equity and equity related instruments with minimum 25% in each category i.e. Large cap, midcap and small cap category.

Equity funds classification according to investing styles

In addition to market cap categories, equity funds can also be categorized according to the investment styles of the schemes.

Dividend Yield Funds: These schemes invest predominantly in high dividend yield stocks. Dividend yield of a stock is the ratio of the dividend paid by the stock to its current market price. High dividend yield stocks are usually mature companies with stable business models and cash-flows. Hence, they are thought to be less risky.

Value Funds: Value funds practise value investing strategy. The funds invest in companies which are trading at a discount to its intrinsic value. This discount in value investment parlance is known as the factor of safety. Fund managers estimate the intrinsic value of a stock after in-depth analysis of the company. Value stocks are usually characterised by relatively low price earnings or price to book multiples and relatively higher dividend yields. Sometimes, value investing is also known as contra investing.

Focused Funds: As per SEBI's mandate, focused funds can invest in maximum of 30 stocks. Since the number of stocks in these funds is limited to 30, they have higher concentration risks than more diversified equity funds. If the fund manager gets his/her stock selection right, then these funds have the potential of delivering superior alphas.

Sectoral or Thematic Funds: According to SEBI's mandate, these funds should invest at least 80% of their assets in a particular sector or theme. Investors should understand the difference between sector and theme. Sectoral funds invest in one industry sector e.g. banking, technology, pharmaceuticals, FMCG, infrastructure etc. An investment theme, on the other hand, can encompass several sectors. For example, consumption theme can cover banking and financial services, automobiles, consumer durables, consumer non-durables, media and entertainment etc. Similarly healthcare theme can cover several sectors in addition to pharmaceuticals, e.g. hospitals, diagnostic centres, wellness products, health insurance etc. Thematic funds are more diversified than sector funds. However, both thematic and sectoral funds have higher sector risks compared to diversified equity funds. Financial advisors suggest that diversified funds should form the core of your equity investment portfolio and you can add thematic or sectoral funds with an aim to augment your returns.

Investors should note that dividend yield funds, value funds, contra funds and focused funds usually follow a multi cap strategy i.e. they invest across industry sectors and market cap segments. Each of these fund categories have their unique risk/return characteristics. You should understand how the fund manager selects stocks before investing in these funds. These funds can be a good addition to your mutual fund portfolio.

Equity Linked Savings Schemes

Equity Linked Saving Schemes (ELSS) are diversified equity funds with a lock-in period of 3 years, i.e. you will not be able to redeem units of these schemes for three years from the date of investment. If you are investing in ELSS through Systematic Investment Plan (SIP), then each SIP instalment will be locked in for 3 years. Investments in ELSS of up to Rs 1.5 lakhs are eligible for deduction from your taxable income under Section 80C of Income Tax Act. You can save up to Rs 46,800 (not including surcharge) in taxes by investing in ELSS. Historical data shows that ELSS have the potential to give superior returns in the long term compared to other 80C schemes like Public Provident Fund, National Savings Certificates, Tax Saver Bank FDs, Life insurance policies etc. However since ELSS are market linked, they carry higher risk than traditional instruments.

Equity linked savings schemes usually follow multi-cap strategy. The lock-in period works to the advantage of investors because the fund managers have less redemption pressures due to the lock-in, and therefore, can stick longer to their high conviction stocks which have the potential to generate superior returns for investors in the long term. Though ELSS have lock-in period of 3 years, financial advisors recommend longer investment tenures for these funds since they have the potential to give better results over longer investment horizons.

Summary

The primary investment objective of equity funds is capital appreciation. In addition to capital appreciation, you can also save taxes by investing in ELSS funds. You should have sufficiently long investment tenure (ideally at least 5 years) and moderately high to high risk appetites for investing in any equity fund. In this article, we have given an overview of different types of equity funds. Different categories of funds have different risk/return characteristics. You should invest according to your risk appetite. You should consult with your financial advisor to understand which equity fund is best suited to your investment needs.

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MIRAE ASSET

Mutual Fund

by Mirae Asset Knowledge Academy

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All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

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