Focused Funds: Seeks power of conviction & concentration

Mirae Asset Knowledge Academy
Profit from Knowledge

The basic tenet of investment is not to put all eggs in one basket - aim for diversification. While it is essential to reduce the overall risk of portfolio by spreading investment in different securities, but just adding more number of stocks to equity portfolio usually diminishes the incremental benefit of diversification beyond a point. In fact, too many stocks in the portfolio may dilute the benefits of performing stocks due to its lower proportion.

Focused funds, as the name suggest, concentrate only on high conviction quality stocks which have potential to create wealth in the long term. The aim is to create a winning portfolio by restricting investments to high conviction stocks with optimal diversification. Focused funds may be an apt investment avenue for investors looking for concentrated equity portfolio. Read on to understand more about the category. Investors are always advised to consult their financial advisors about these funds since the risk is moderately high.

What are focused funds?

As per SEBI's mandate, a focused fund can invest in a maximum of 30 stocks with a minimum exposure of 65% of the portfolio in equity and equity-related instruments. Focused funds can invest across market capitalisation - i.e. large cap, mid-cap and small cap. Analysis of a portfolio of CRISIL-classified focused funds in February 2019 shows that 15 out of 18 funds invested more than 60% in large cap stocks (Source: Crisil Research as on Feb 28, 2019).

Table 1: Market cap exposure of focused funds

Market cap exposure (%)	Large cap	Large cap	Large cap
Max	90	20	24
Min	47	3	0

Portfolio data as of February 28, 2019. Source: CRISIL Research.

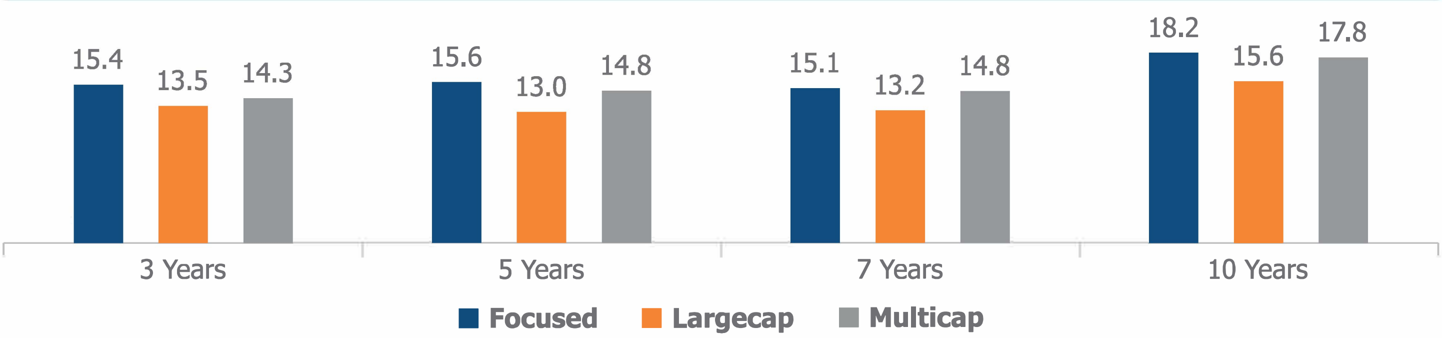
While other equity funds do not have a limit on the investment to maximum number of stocks, focused funds restrict the investments to 30 stocks. Studies have shown that unsystematic risk as evaluated through standard deviation usually reaches optimum levels once a portfolio is diversified across 20-25 stocks.

Seeks power of conviction and concentration

With the mandate to manage a concentrated portfolio, a fund manager of focused fund endeavours to choose only high conviction quality companies identified after undergoing stringent research, with a clear focus on risk management as per the investment strategy of the scheme. The objective of these funds is to aim to achieve high growth by investing in a limited number of quality companies with high growth potential.

Performance analysis shows that focused funds have managed to potentially perform better than largecap and multi-cap funds across periods taken into consideration (Refer to Chart 1).Focused funds have given CAGR of 18.2% over a longer time frame of 10 years, higher as compared with 15.6% CAGR and 17.8% CAGR provided by large cap and multi cap funds category respectively (Source: Crisil Research, as on March 31,2019).

Chart 1: Performance across horizon

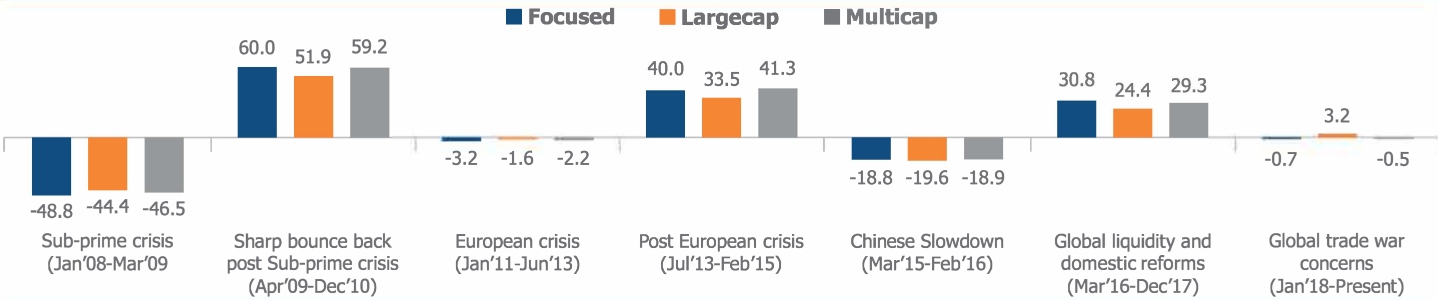


Annualised returns as on March 29, 2019. Category average based on CRISIL classification. Source: CRISIL Research

True to their label, focused funds maintain a concentrated portfolio. For instance, top 15 stocks account for, on average, 74% of total focused funds' portfolio, while for large cap and multi-cap focused funds, it is 65% and 57%, respectively, as per the February 2019 portfolio (Source: Crisil Research, as on Feb 28, 2019).

A concentrated portfolio helps focused funds perform potentially better during market uptrends. However, it should be noted that with high growth comes high risk, as showcased during market downtrends (Refer to Chart 2).

Chart 2: Market phase performance

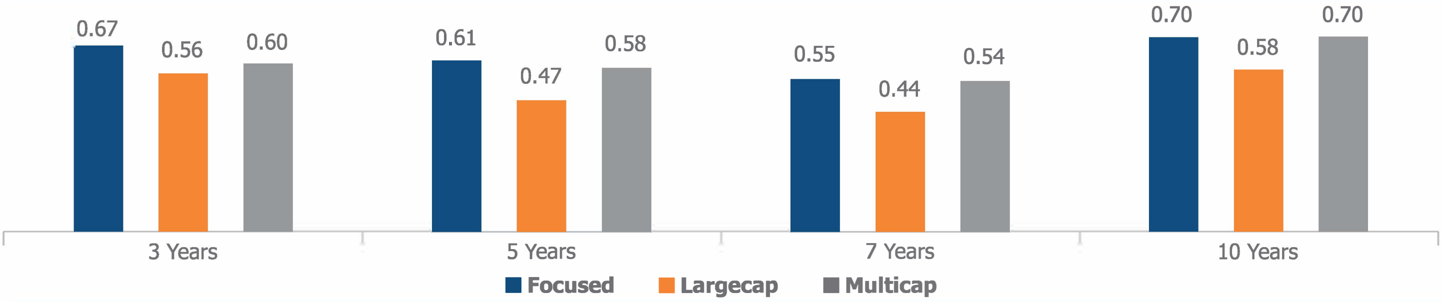


Category average based on CRISIL's classification. Source: CRISIL Research, as on March 31, 2019.

Optimal diversification: Aims better risk-adjusted performance

Concentration does not necessarily mean high risk. Despite a concentrated approach, focused funds strive for optimal diversification across a limited number of stocks, sectors and market cap. With this allocation, they aim to give potentially better risk-adjusted performance. As seen in the chart 3, focus funds have better Sharpe ratio, a risk adjusted measure, as compared with large cap and multi cap funds across horizon (Source: Crisil Research, as on Mar 31, 2019).

Chart 3: Risk-adjusted performance (Sharpe ratio)



Category average based on CRISIL's classification. Source: CRISIL Research, as on March 31, 2019.

Summary

Focused funds are suitable for aggressive investors looking for high growth by investing in a concentrated portfolio in the long run and who have a relatively higher risk appetite. As few stocks have a higher proportion in the portfolio, performance of these stocks can significantly impact the fund's performance (both ways).

In a nutshell, aggressive investors can consider focused funds to earn potentially higher returns from a concentrated yet optimally diversified portfolio in the long run.

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