

Fund of Funds

A Non-Starter



Fund of Funds (FoF) have proved to be non-starters in the history of the mutual fund industry in India. From 1993, when Sebi in its Board meeting approved the concept of FoF till date, the schemes have failed to scale even a respectable level of volumes.

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Returns from FoF have not ever surpassed either equity schemes or balanced fund schemes in general. FoF were looked upon as a dynamic vehicle for AMC's to foray into the stock market by identifying best performing schemes and purchasing units in such schemes. For instance, a combination of two best performing funds from two different fund houses for equities, and two best performing funds from altogether different fund houses for debt would have enabled the FoF to get access to proven skills rather than reinvent the wheel or try mimicking these funds by ab initio starting with an NFO. It is like an IPL

cricket team which is not restricted to picking cricketers from its own country but taking the best from all good teams globally so as to form an unbeatable team. Sadly, this has not happened. By very definition, FoF are a class of mutual funds that invest primarily in the units of other mutual funds. But the industry is yet to see such a happening except a couple of funds.

FoF also score for the reason that they offer much greater diversification. They achieve this by holding onto units of mutual funds each one of which itself strategizes their holdings to lower risk.

Returns from balanced funds—i.e., funds which could be taken as comparable to FoF schemes though they are not FoF schemes, outclass FoFs (see table Top Performers).

Within FoFs, the comparison of FoFs—overseas and FoFs—domestic brings out sharply the superior returns of overseas. The rank of top FoFs belongs to the category overseas.

The two highest returns from FoF schemes as on March 14, 2011 for a one year period are from 'overseas' category, and surprisingly, the reason for their high performance is due to their investment in a commodity—gold. The AIG World Gold Fund Growth has shown highest performance where the investment of this fund is in AIG PB Equity Fund Gold. The second highest performance is from DSP Blackrock World Gold Fund – Growth, and here also, the predominant investment is in Merrill Lynch IIF World Gold Fund.

Popularity of FoF schemes

In India, FoF schemes suffer from immense lack of popularity.

Totally, 41 funds are operating their schemes but only 8 out of these 41 are offering FoF schemes. The ratio of AUM of funds offering FoF schemes is not even half percent i.e., just 0.41% of the total AUM.

Even within fund houses offering FoF schemes, the AUM of FoF schemes is only 1.27% of the AUM of the fund houses.

Although very few fund houses are offering FoF schemes, the larger ones seem to be offering them as can be seen in table FoF Schemes AUM as Per cent of Fund Houses Total AUM.

However, there is no clear pattern of share of the total AUM and FoF schemes. The largest per cent of FoF schemes (Domestic) within a fund

Top Performers – 1 Year Returns: Balanced Funds vs. Domestic FoFs

Rank	Balanced Fund	Return	Fund of Funds	Return
1	HDFC Prudence	13%	ING Multi Mix 5 Star FoF Scheme	8.7%
2	HDFC Balanced	12%	ICICI Prudential Aggressive Plan	7.9%
3	Baroda Pioneer Balance	11%	Quantum Equity FoF	7.7%
4	Birla Sun Life 95	10%	FT India Life Stage Fund of Funds	7.5%
5	ICICI Prudential Balanced	9%	Fidelity Wealth Builder – Plan C	7.4%
6	Canara Robeco Balance	8%	FT Dynamic PE Ratio FoF	7.3%
7	DSP Blackrock Balanced	7%	IDFC Asset Allocation FoF Moderate	5.4%
8	Sundaram Balanced	7%	ICICI Prudential Cautious Plan	5.4%
9	UTI Balanced	6%	Birla Sun Life AAF Conservative	5.0%
10	Franklin Templeton India Balanced	6%	Kotak Equity FoF	2.6%

Source: MutualFundsIndia.com website - performance taken 15th March 2011 - only Growth Plans

house is from ING followed by IDFC, Franklin Templeton and Fidelity.

Benchmarking performance

An appropriate way to evaluate an FoF is to benchmark it with a balanced fund. The reasons are as follows:

- ◆ The FoF typically invests in units of equity mutual funds for the most part, and the rest would be debt mutual funds/cash. This would be very comparable to balanced funds.
- ◆ The objective of the investor would be to diversify the holdings by investing in a FoF. The same objective is achieved by investing in a balanced fund.

The comparison has been made between two funds from the Franklin Templeton stable: the FT India Balanced Fund – Growth (referred to as 'Balanced' hereafter), and FT India Life Stage Fund of Funds – the 20s Plan (referred to as '20s'). This FoF has been chosen, as the allocation of portfolio between equities and debt is 80:20 which comes closest to the Balanced which has an allocation of 69:31.

What has the investor achieved by putting money in the 20s instead of FT India Balanced Fund Growth?

Portfolio differences

- ◆ The 20s is supposed to be a choice of superior mutual funds so as to give the investor better returns with less risk. It is very interesting to observe that the 20s has invested in 5 mu-

tual funds, all from the Franklin Templeton stable as follows:

- Portfolio of 20s: AUM Rs 12 cr end February 2011.
- 5 stocks all being Franklin Templeton Mutual Funds (i.e., 100%).
- Balanced fund: AUM Rs 258 cr end February 2011.

The Balanced Fund has 10 major scrips accounting for 42% of the portfolio. In contrast, 20s has much more distributed holdings. For example, Bharti Airtel forms 7.75% of the Blue Chip Fund and 2.65% of the Prima Fund. But if the weighted average is taken, the share of Bharti Airtel in 20s is 4.25%, which is much lower than 5.11% in Balanced.

In spite of the wider range of holding, the returns from the 20s are not signifi-



cantly higher than that of Balanced, at the same time the volatility is higher.

The cash holding in the debt funds is very high and this in turn would affect the returns generated by the FoF considering that this would be in addition to the cash holding of the FoF per se.

For the period under comparison here the return from 20s could not cover the risk free rate and hence Sharpe and Sortino are negative. Further, the 20s is supposed to be bringing about greater stability due to higher diversification. This is supposed to lead to lower volatility. But the downside appears to be worse for 20s as compared to Balanced since the Sortino is higher. The 20s there-

FoF Schemes AUM as Per Cent of Fund Houses Total AUM

(Rs Cr)

Fund House	All Schemes	FoF Schemes	FoF to Total (%)
ING	1,386	156	11.24
IDFC	17,348	804	4.63
Franklin Templeton	39,443	1,532	3.88
Fidelity	8,901	138	1.55
Quantum Equity	117	2	1.48
Kotak	27,565	77	0.28
Birla	57,689	39	0.07
ICICI Prudential	65,841	36	0.05
Total Funds Offering FoF	2,18,290	2,783	1.27
Others	4,57,087	0	0.00
Total All Funds	6,75,377	2,783	0.41

Source: AMFI website. Figures of AUM are averages from October-December 2010.

Portfolio Differences			
Scheme	Ratio (%)	Expense Ratio (%)	Cash (%)
Blue Chip	50	1.85	8
Prima Fund	15	2.07	7
Growth Fund	15	2.21	6
Income Fund	10	1.71	57
Income Builder Account	10	1.6	46
Total/weighted average	100	1.90	NA

Benchmark Index Returns	
Fund/Index	Return
20s	7.51%
Balanced	5.61%
CRISIL Balanced Fund Index	19.78%

Source: Mutualfundsindia.com, March 15, 2011

fore have not met this objective also. The Treynor ratio which compares the excess of returns over the risk-free rate per unit of beta is also worse for 20s. The 20s are not as strongly correlated with the benchmark as the Balanced.

Expense ratio

One of the major drawbacks of the FoF schemes is that it charges an expense ratio to the investor, over and above the expense it pays on the funds it invests in. There is a brief background to the developments here. One of the strategies to earn revenues was offshore funds. AMC's with FoF schemes started having revenue sharing arrangements for investments in offshore funds. Considering this as inappropriate, Sebi decided that such revenue should be credited directly into the P&L of the scheme account and hence banned the practice of entering into such revenue sharing agreements, but when the fund houses started panicking, decided to offer more flexibility on expense ratios. The maximum that a FoF can charge is:

Performance: 20s vs. Balanced					
Fund	Sharpe	Beta	Treynor	Sortino	Correlation
Balanced	-0.09	0.93	-0.37	-0.16	0.96
20s	-0.10	0.64	-0.60	-0.17	0.64

Source: MutualFundsIndia.com, data period 12 months ended March 16, 2011

Either:

- ◆ The total of the following components subject to a cap of 2.5%:
 - Management fee not exceeding 0.75% of the average net assets, plus
 - The expenses of administration of the scheme, plus
 - On the average net assets of the scheme, expenses being Weighted Average of Total Expense ratio of underlying schemes.

Or:

- ◆ Annual expenses capped at 2.5% of the weekly average of net assets, left to the choice of the fund.
- Thus, FoFs now have a choice of what method to choose.

Benefit-costs to investors

The investor spends additionally the expense ratio by investing in FoF but saves indirectly capital gains when the FoF does a rebalancing of portfolio to suit his risk temperament. For instance, Franklin Templeton's Stage of Life Fund of Funds does rebalancing between Equity and Debt every six months. If the investor wishes to have a portfolio of 80:20::Equity:Debt, and the equity component goes well beyond 80% due to a boom in the stock market, he would have to incur short-term capital gains tax if he sold the excess portion of equity to bring the percentage to 80%. If he invests in FoF, the fund would sell the shares and insulate the investor from the capital gains otherwise payable.

Tax – The dampener

One of the greatest deterrents to investors has been the tax disadvantage arising out of the classification of FoFs. FoFs are treated as debt funds even

Balanced Fund: AUM Rs 258 cr (Feb. 2011)		
Rank	Scrip	Portfolio % where Equity = 69%
1	Infosys	6.49
2	Kotak Mahindra Bank	6.15
3	Bharti Airtel	5.11
4	ICICI Bank	4.87
5	Reliance Industries	4.20
6	Cummins	4.16
7	Hindustan Unilever	2.94
8	Grasim	2.90
9	HDFC Bank	2.68
10	Marico	2.60
Total		42.10

though they may choose to invest in equity funds. The dividends payable by FoFs are liable to payment of dividend distribution tax by the scheme which is not the case with equity mutual fund schemes. If the same investment had been made in equity funds which have not less than 65% of their investments in equities, the investor would have been spared (indirectly) the incidence of income tax on dividends. Capital gains—both short-term and long-term are adverse for the investor in a FoF unlike equity schemes. Long-term capital gains are exempt for equity schemes but the investor has to pay tax—albeit with benefit of indexation if he chooses in a transaction involving FoF.

Conclusion

FoFs have enormous potential to generate high returns and save the investor the botheration of tracking efficiency of individual mutual funds. The very concept of a mutual fund was to benefit investors interested in securing better returns without increasing risk by leveraging on the professional skills of mutual fund managers. FoFs are a notch superior in that even studying individual mutual fund scheme performances can be eliminated for the investor. But FoFs have failed the test on almost all counts and they may become extinct unless AMC's pull up their socks and ramp up the FoF show. ■

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