An Investor Education Initiative
MIRAE ASSET
Mutual Fund
by Mirae Asset Knowledge Academy

BUILD CORE PORTFOLIO AROUND LARGE CAP ETFs TO BEAT VOLATILITY

The Covid-19 pandemic delivered a blow to the equity market and the resultant volatility notwithstanding, large companies with stable businesses, significant market presence, strong cash flows and steady dividend payout continue to fare better than others. Their stocks have outperformed the broad market and stocks in the lower market capitalisation (cap) band. In this backdrop, large cap offers a good investment opportunity and this article highlights the benefits of investing in these stocks via Exchange-Traded Funds (ETFs).

Why large cap?

Large cap companies have stable businesses. Given their size and track record, these companies are relatively less volatile during market downturns and good compounders in the long term. Run by experienced management, large caps are at the matured life cycle stage compared with mid-sized and small companies, which are in the middle or early life cycle stage and more vulnerable to a business or economic downturn. Recent data stands testimony to this fact.

Large cap represented by Nifty 50 TRI and Nifty Next 50 TRI, fell less than the small and mid-cap (Nifty Smallcap 100 TRI and Nifty Midcap 100 TRI) in the one year ended June 30, 2020. Nifty 50 TRI and Nifty Next 50 TRI lost 12% and 5%, respectively, compared with 16-25% fall in small and mid-cap.

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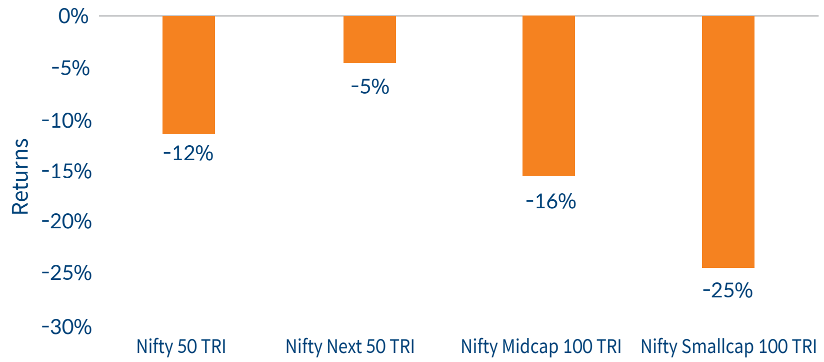
Source: CRISIL Research

Chart 1: Large cap fared better than small and mid-cap during the recent market carnage.



Notes: Data for the one year ended June 30, 2020.
Source: CRISIL Research
Past performance may or may not be sustained in future.

Investors can invest in these stocks through a professional fund management route.

How to invest?

In volatile times, investors typically wonder if they should start investing in large cap directly. Well that's tricky considering the amount of money needed to invest directly in each of the 100 large cap stocks (as per Securities and Exchange Board of India definition). It is probably better to take the mutual fund route.

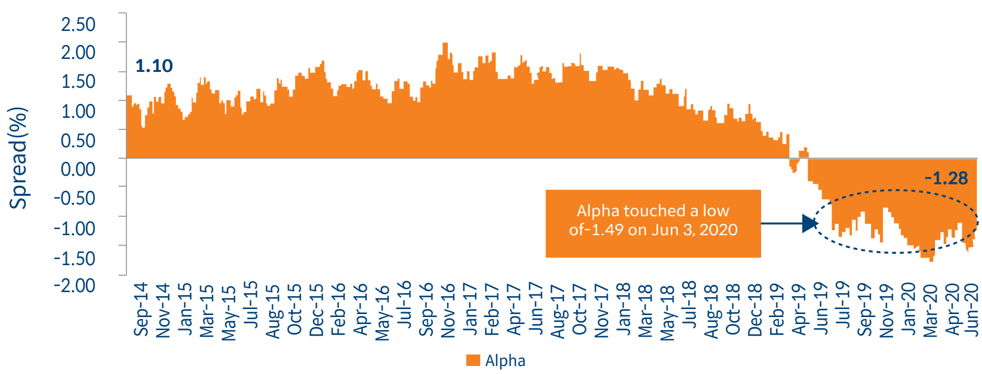
Investors can opt for investing through actively managed mutual funds or passively managed mutual funds such as ETFs, which mirror large cap indices. The latter is relatively cheaper than actively managed funds. For instance, the average expense ratio as per the May 2020 portfolio (cost charged by investment companies to investors for managing their money) is 0.33% in ETFs (Nifty 50 and Nifty Next 50 ETFs) as against 2.20% in actively managed large cap funds. This means a gap of nearly 187 basis points, which can make a huge difference in the long term.

Source: CRISIL Research, dated as on June 30, 2020.

Additionally, falling alpha of actively managed funds has reduced the benefit for investors as compared to passively managed funds.

CRISIL analysed the alpha spread by taking the five-year daily rolling returns of large cap funds versus the Nifty 50. The alpha has dropped sharply since December 2019 and touched a low of -1.49 on June 3, 2020.

Chart 2: Consider investing in ETFs amid dip in alpha of actively managed funds versus benchmark.



Notes: Alpha is the difference between the daily five-year annualised rolling returns of a weighted large cap fund performance index based on CRISIL-ranked large cap funds and Nifty 50 TRI as on June 30, 2020.
Source: CRISIL Research

Thus, ETFs either in the conventional broad market index such as the Nifty 50 or Nifty Next 50, can act as a stable, diversified and low-cost supplement to the existing active investment portfolio.

The performance of the Nifty 50 TRI index has been on par with large cap funds.

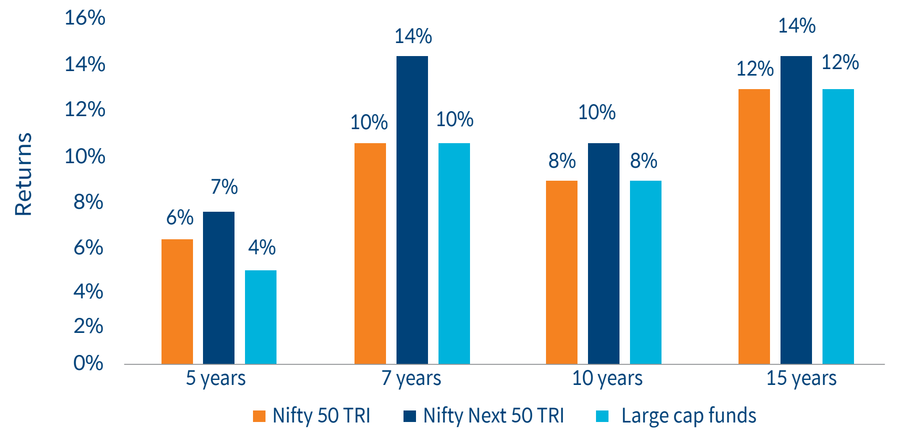
Why Nifty 50 and Nifty Next 50?

The Nifty 50 and Nifty Next 50 indices encompass the entire large cap universe in the domestic stock market. The Nifty 50 is the older and more tracked index between the two and comprises the top 50 large cap stocks in the country, while the Nifty Next 50 index represents the next 50 companies in the large cap universe in the market cap order.

Performance analysis

Historical performance analysis of these indices versus large cap funds shows that Nifty Next 50 TRI has consistently outperformed large cap funds. Performance of the Nifty 50 TRI has been on par with large cap funds.

Chart 3: Point to point returns of Nifty 50 TRI, Nifty Next 50 TRI vis-à-vis large cap funds.

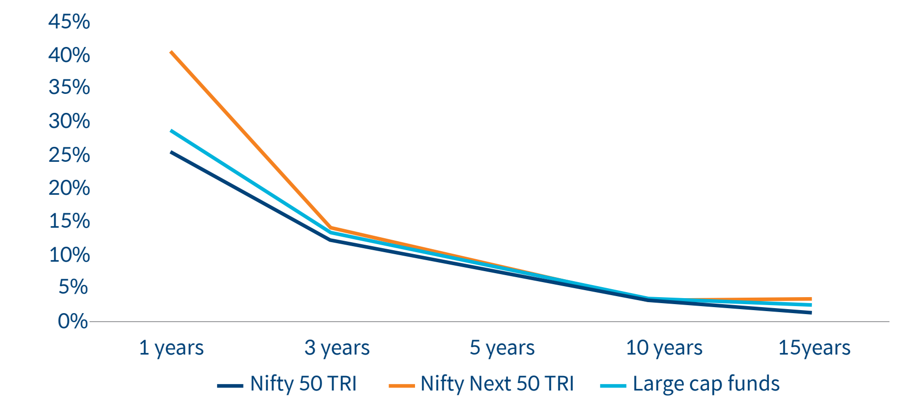


Notes: Point-to-point returns for the period ended June 30, 2020.
Large cap funds are represented by weighted large cap fund performance index based on CRISIL-ranked large cap funds.
Source: CRISIL Research
Past performance may or may not be sustained in future.
The data/performance provided above pertains to the category/index and does not in any manner constitute performance of any individual scheme of Mirae Asset Mutual Fund.

Decent performance has also come with low volatility which is one of our primary factor of investing in these volatile times.

Decent performance accompanies low volatility, which is one of the primary factors of investing in volatile times. Volatility measured by standard deviation was 13% and 15%, respectively for Nifty 50 TRI and Nifty Next 50 TRI, compared with 14% for large cap funds during the three-year holding period. Volatility tends to reduce over the long-term, as evident in the chart.

Chart 4: Volatility of Nifty 50 TRI, Nifty Next 50 TRI vis-à-vis large cap funds.



Notes: Volatility is represented by standard deviation.
Time period of analysis is from January 1, 2001 to June 30, 2020.
Large cap funds are represented by weighted large cap fund performance index based on CRISIL-ranked large cap funds.
Source: CRISIL Research

Market phase analysis reveals that performance of the Nifty 50 has been in line with or below that of large cap funds across most bull and bear periods. Further, the Nifty Next 50 has fallen less than large cap funds during the recent Covid-19 crisis and also during the Chinese slowdown in 2016. Nifty Next 50 has rebounded well compared with large cap funds post the subprime and euro zone crises.

Table 1 - Market phase analysis

Period	Nifty Next 50 TRI	Nifty 50 TRI	Large cap funds
Subprime crisis (Jan 2008-Mar 2009)	-57.1%	-42.8%	-43.4%
Sharp bounce-back post subprime crisis (April 2009-December 2010)	81.5%	50.4%	52.9%
European crisis (January 2011-June 2013)	-1.2%	-0.7%	-1.1%
Post European crisis (July 2013-February 2015)	37.2%	29.4%	33.1%
Chinese slowdown (March 2015-February 2016)	-12.1%	-20.6%	-18.7%
Global liquidity and domestic reforms (March 2016-December 2017)	38.0%	24.5%	26.7%
Mixed domestic and global scenario (January 2018-December 2019)	-3.1%	9.5%	4.0%
Covid-19 pandemic (January 2020-June 2020)	-8.6%	-15.0%	-15.1%

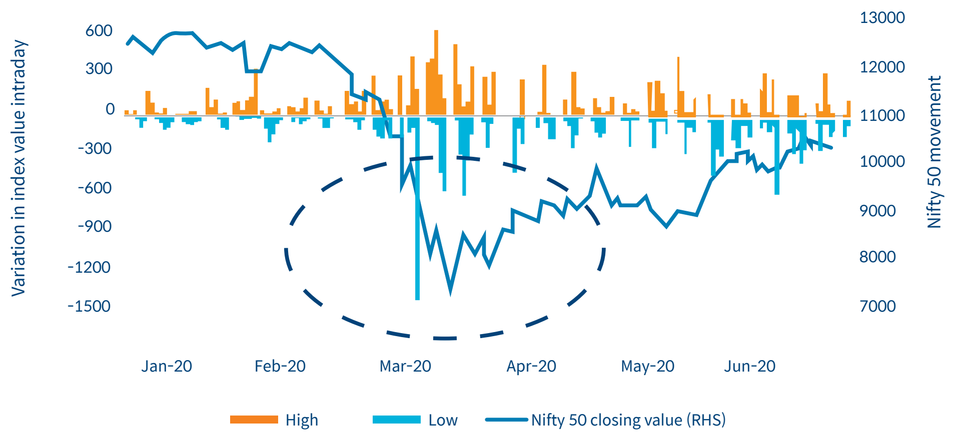
Notes: Large cap funds are represented by weighted large cap fund performance index based on CRISIL-ranked large cap funds.
Returns above one year are annualised, otherwise absolute.
Blue highlight signifies best performers across each phase.
Source: CRISIL Research

ETFs thus provide a tactical opportunity to invest based on market volatility.

Side note: An intraday tactical opportunity

Investors can buy and sell ETFs intraday or at any time during the market hours, unlike traditional equity mutual funds, where they get the closing net asset value (NAV) for investment. ETFs provide a tactical opportunity to invest based on market volatility. For instance, as seen from the chart below, investment in ETFs during volatility periods, which correlates to market lows, allows investors to buy more units, thus getting a better purchase for their investment over the long term.

Chart 5: Nifty closing versus its intraday high and low closing value.



Notes: Data from January 1 to June 30, 2020.
High represents the variation in absolute value of the high point of the index intraday versus that day's closing value.
Low represents the variation in absolute value of the low point of the index intraday versus that day's closing value.
Source: National Stock Exchange of India

Summing up

Inclusion of Nifty 50 and Nifty Next 50 ETFs to the investment portfolio is a good tactical strategy.

However, due diligence of schemes in terms of expense ratio, tracking error (a measure of how closely the index fund's returns match its benchmark returns) and track record of the fund house is a must. Investors should not panic when unprecedented events batter the stock market, instead hold on to the investments for the long term.

An investor education initiative by Mirae Asset Mutual Fund.

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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