WHY YOU SHOULD AVOID NFOs

A large number of NFOs hitting the market doesn't mean that you should invest in all of them.

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By Narendra Nathan

Stock market peaks are usually accompanied by a flood of new fund offers (NFOs) from asset management companies. This year was no different. The number of open-ended equity NFOs being launched zoomed in the October-December quarter.

While mutual funds ask investors to avoid the herd mentality, they practice the opposite by all coming out with NFOs at the same time. A look at the recent NFOs will reveal that many of them were dedicated to the environmental, social and governance (ESG) theme. "Almost every AMC is launching ESG funds now, because they want to fill that gap in their product portfolio," says Arun Kumar, Head of Research, FundsIndia. There is another reason behind the rush. "After the recent categorisation, AMCs can't launch another scheme from the same category and therefore, they are on the lookout for new themes that will

There has been a sudden rush of open-ended equity NFOs

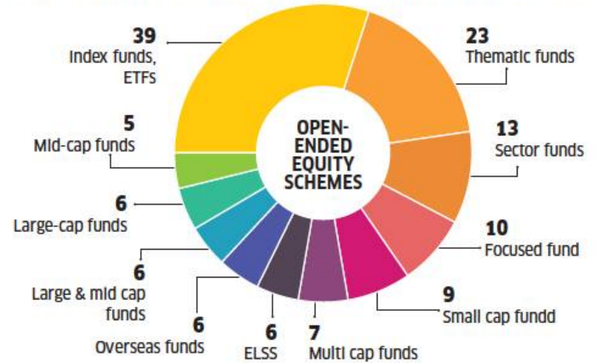
Investors can avoid this seasonal rush.

YEAR-QUARTER	NFOS LAUNCHED
2018-1	1
2018-2	4
2018-3	10
2018-4	15
2019-1	16
2019-2	7
2019-3	15
2019-4	14
2020-1	9
2020-2	5
2020-3	9
2020-4	25

Source: Value Research, ACE MF; Compiled by ETIG Database

In absence of restrictions, sector and thematic funds continue to pop up

Make sure the theme or sector fits into your portfolio before investing.

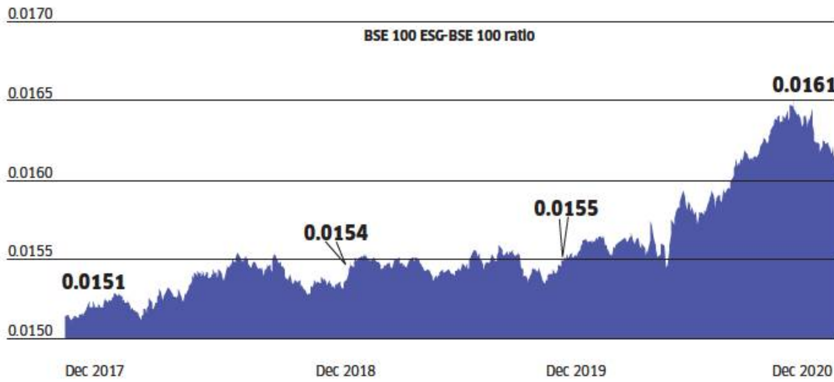


Note: based on past 3 year data

Source: ACE MF; Value Research; Compiled by ETIG Database

Profusion of ESG funds in past two years after theme rallied

But most NFOs have come out when the ESG theme has started underperforming.

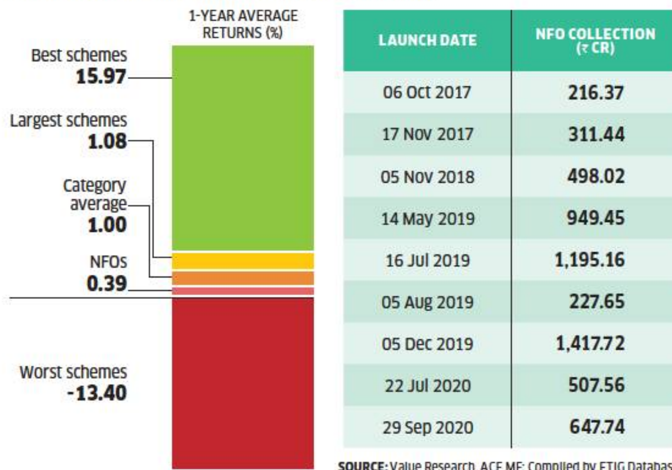


SCHEME	LAUNCH DATE
Aditya Birla Sun Life ESG Fund	24 Dec 2020
Kotak ESG Opportunities Fund	11 Dec 2020
Mirae Asset ESG Sector Leaders Fund of Fund	18 Nov 2020
Mirae Asset ESG Sector Leaders ETF	17 Nov 2020
Quant ESG Equity Fund	6 Nov 2020
ICICI Prudential ESG Fund	9 Oct 2020
Axis ESG Equity Fund	12 Feb 2020
Quantum India ESG Equity Fund	12 Jul 2019

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

Focused NFOs failed to perform

There is nothing unique about the focused strategy.



LAUNCH DATE	NFO COLLECTION (₹ CR)
06 Oct 2017	216.37
17 Nov 2017	311.44
05 Nov 2018	498.02
14 May 2019	949.45
16 Jul 2019	1,195.16
05 Aug 2019	227.65
05 Dec 2019	1,417.72
22 Jul 2020	507.56
29 Sep 2020	647.74

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

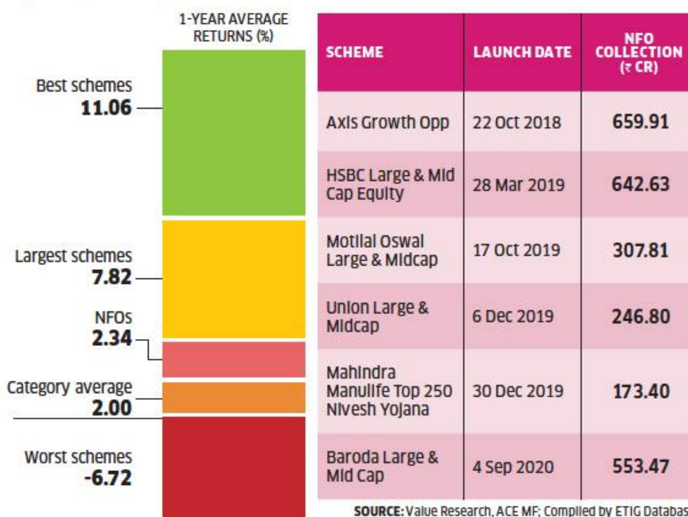
do well in future and will also generate investor interest," says Ankur Maheshwari, CEO, Equirus Wealth Management.

The first ESG scheme was launched by Quantum India in July 2019. The scheme failed to generate any excitement among other AMCs as it collected only ₹11 crore. Though SBI Magnum Equity ESG Fund has a longer track record, it's a renamed fund and was earlier known as SBI Magnum Equity Fund. The excitement around the theme grew after Axis AMC launched an ESG fund in February 2020 and collected ₹1,738 crore. Suddenly all fund houses wanted to fill the ESG gap in their product portfolio.

AMCs have also realised the virtues of focussed holdings. This tilt towards increased risk is a bull market phenomenon. Though there was no dedicated focussed

Large & mid-cap NFOs did not shine

Investments in existing large schemes would have yielded better returns.



SCHEME	LAUNCH DATE	NFO COLLECTION (₹ CR)
Axis Growth Opp	22 Oct 2018	659.91
HSBC Large & Mid Cap Equity	28 Mar 2019	642.63
Motilal Oswal Large & Midcap	17 Oct 2019	307.81
Union Large & Midcap	6 Dec 2019	246.80
Mahindra Manulife Top 250 Nivesh Yojana	30 Dec 2019	173.40
Baroda Large & Mid Cap	4 Sep 2020	553.47

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

funds category back then, the first focussed fund was launched in March 2008 —JM Core 11 with a portfolio of just 11 stocks. It failed miserably and after 13 years of existence, its NAV was ₹9.85 as on 16 December 2020. The focused fund NFOs have also not done too well compared to existing schemes over the past five years (*see chart*). Their average returns are less than that of the largest scheme and the category average. This is one of the reasons why experts ask investors to be sceptical of NFOs. "Investors should not think that NFOs are special. Though they may be new funds, the money collected through NFO is invested in the same pool of stocks," says Gaurav Rastogi, CEO, Kuvera Wealth.

Most other recent NFOs in other categories are attempts by AMCs to fill gaps in their respective portfolios. In several cases, fund houses have merged existing schemes to create gaps in their portfolios and make space for NFOs. The NFOs in categories like large-caps, large & mid-caps, mid-caps and small-caps from very old fund houses are cases in point. NFOs from new AMCs like Mahindra Manulife, ITI, etc are attempts to cover the entire product bucket. Experts says investors can avoid these 'me too' new offerings. "Check whether there is any uniqueness in them. In other words, whether this is new only for that AMC or new for the mutual fund industry as well," says Tanwir Alam, Founder & CEO, Fincart.

When the average 1-year NFO returns are similar to that of the category average, it would seem there is little point in entering the NFO space. However, NFOs from the small-cap category have been able to do well compared to existing schemes. "Size plays an important role in small-cap funds and since the starting size will be usually small, small-cap NFOs may do well.

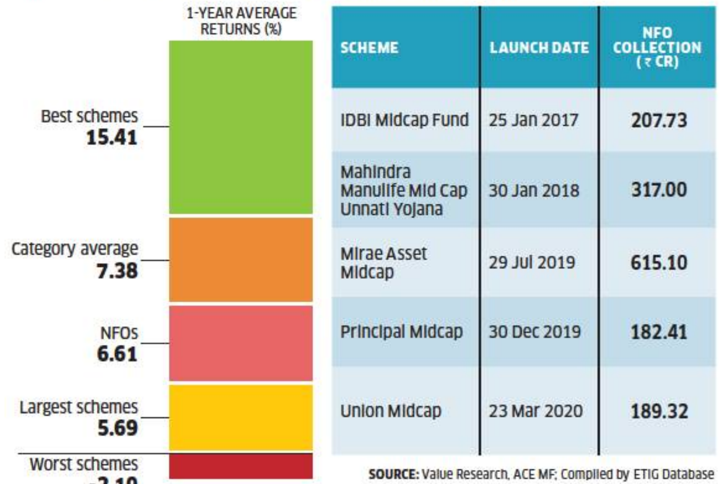
NFOs of close-ended funds and ETFs best avoided

The restriction of one scheme per category is not applicable for close-ended funds and that is why there is a profusion of NFOs in this space. Investors of close-ended funds should be extra careful because the attention given by AMCs to these is much less compared to open-ended funds. In a close-ended fund, the money is locked in, usually for 3-5 years. Though these units are listed on the exchanges, they usually trade below their respective NAVs. While the seller (existing investor) is trapped and has to sell it, the buyer (prospective investor) has several options. This demand-supply mismatch creates the discounts.

Similarly, it makes sense to avoid exchange traded funds (ETFs) even it is a unique product. Invest in it only after it starts trading normally, a few days after the NFO closes. ETFs are index funds listed in stock exchanges and traded regularly like stocks. Traded volume and the bid-ask spread (difference between the quoted buying and selling price) are critical for ETFs. Since that can't be assessed at the time of an NFO's launch, investors can get stuck if the counter becomes illiquid after listing. If an ETF is not traded actively, its market price can also move away significantly from its NAVs. ETF NFO investors also face another peril—fractional units or partial refund of interment amount. "While countries like US allow trading in fractional units, it is not allowed here, creating the problem of fractional units or partial refunds," says Vidya Bala, Co-Founder, PrimeInvestor.in.

Mid cap NFOs lagged category average

Investors who avoided these category filling offers benefitted.

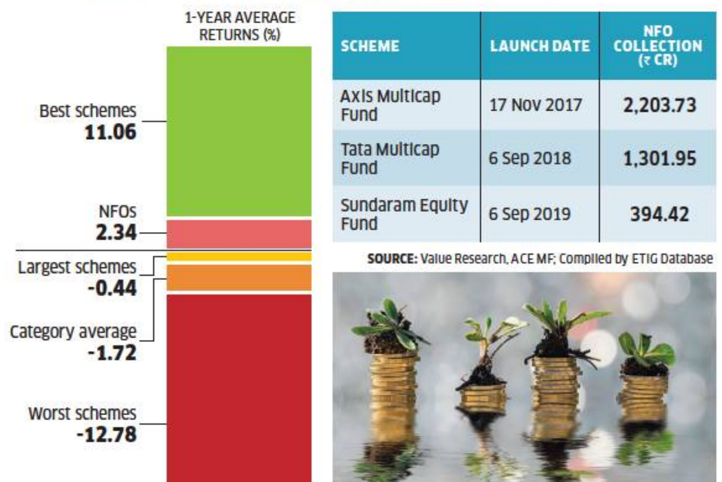


SCHEME	LAUNCH DATE	NFO COLLECTION (₹ CR)
IDBI Midcap Fund	25 Jan 2017	207.73
Mahindra Manulife Mid Cap Unnati Yojana	30 Jan 2018	317.00
Mirae Asset Midcap	29 Jul 2019	615.10
Principal Midcap	30 Dec 2019	182.41
Union Midcap	23 Mar 2020	189.32

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

Multi-cap NFOs did better than expected

Category average lifted by good performance of Axis Multicap.

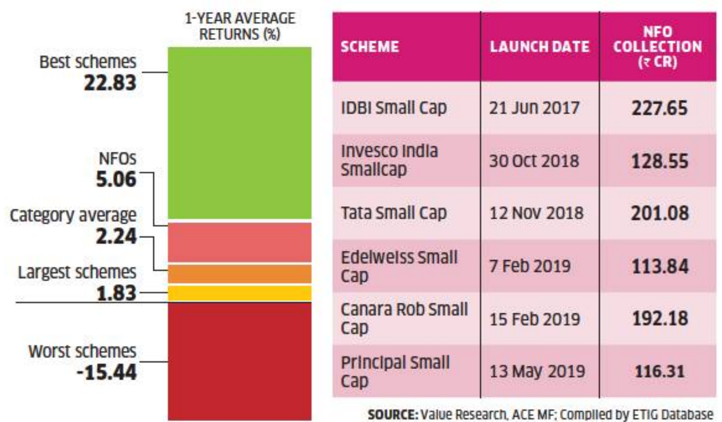


SCHEME	LAUNCH DATE	NFO COLLECTION (₹ CR)
Axis Multicap Fund	17 Nov 2017	2,203.73
Tata Multicap Fund	6 Sep 2018	1,301.95
Sundaram Equity Fund	6 Sep 2019	394.42

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

Small-cap NFOs outdid existing schemes

Even then investors should go by fund manager's track record.



SCHEME	LAUNCH DATE	NFO COLLECTION (₹ CR)
IDBI Small Cap	21 Jun 2017	227.65
Invesco India Smallcap	30 Oct 2018	128.55
Tata Small Cap	12 Nov 2018	201.08
Edelweiss Small Cap	7 Feb 2019	113.84
Canara Rob Small Cap	15 Feb 2019	192.18
Principal Small Cap	13 May 2019	116.31

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

However, investors should restrict themselves to NFOs where the fund manager has a good track record," says Kumar.

Most investors chase historical returns and tend to enter the market close to the peak. Fund houses also try to benefit from this wrong investor behaviour by launching NFOs when the market is at an all-time high to increase their assets under management (AUM). After all, AMCs earn on the basis of asset management fee charged on the AUM. Most theme-based offerings come after a particular theme starts giving good historical returns. The ESG flood happened only recently and that too after this theme generated good historical returns. "The market is hot now and AMCs know that it is a good time to raise money. However, a heated market is not the best time to invest, so investors can skip most NFOs," says Alam.

Most of the NFOs launched in the past five years are from the thematic and sectoral funds space. The reason is while Sebi allows only one scheme per category, it was not able to impose the same restrictions on sector and thematic categories. This is because they are 'umbrella categories' and there can be several sub-categories within. For example, AMCs can launch one scheme per sector or theme. These sectors and themes also keep evolving. For example, there was no ESG theme a few years back and it seems the most sought-after today. "Sector or thematic funds are not a great idea for retail investors because these themes and sectors go through their own cycles," says Alam. Since sector or themes are not defined clearly as market caps, an AMC can have a thematic scheme based on value investing and another on dividend yield.

Since there is no restriction on the number of index funds one AMC can have, AMCs continues to launch NFOs after NFOs in the open-ended index funds and index ETF space (*see box*).

Though there is no advantage in investing in an NFO, overseas funds help investors achieve geographical diversification and are worth considering. Since most of them are using the fund of funds route, investors can also check the track record of the primary fund. Some of them, like Kotak International Reit, give exposure to areas like Reit, which are not available in India.

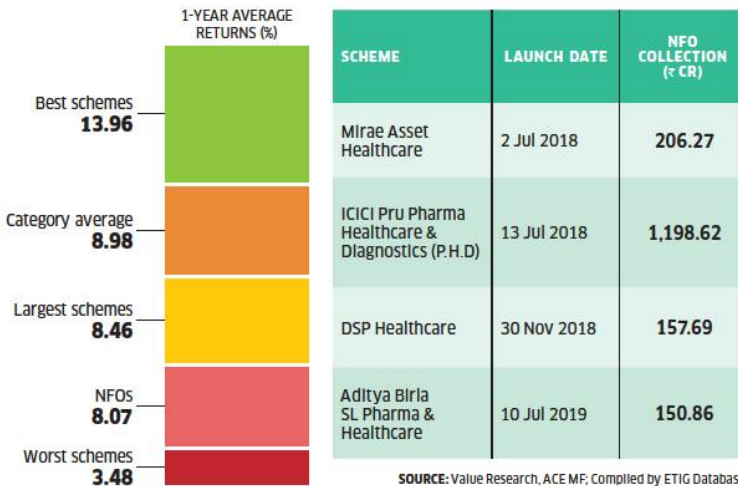
Among the sector funds, the pharma sector has seen maximum launches. However, AMCs were more judicious with pharma fund launches and most of them happened when the sector was at lower levels and therefore, the NFOs were able to generate decent returns. The underperformance of these NFOs was also low – 8.07% vs the category average return of 8.98%.

What you should do

As mentioned earlier, investors can ignore most NFOs because there will be several existing schemes with good track records in the same space. However, it makes sense to invest in some NFOs. "Investors should not paint all NFOs with the same brush. While they can avoid common themes, they should evaluate the niche NFOs," says Kumar. Study the fund objective and make sure that it is unique. However, there is no need to jump into every unique product. "Investors should ask – do I actually need this new product?" says Alam, Founder & CEO, Fincart. "Even if an NFO is unique, consider it only if will add value to your fund portfolio and its risk profile and time frame matches yours," says Vidya Bala, Co-Founder, *Primeinvestor.in*. The next step is to see the AMC / fund manager's track record as the NFO will not have any track record.

Pharma NFOs could not beat category average

Sector and thematic funds are best left for evolved investors.



SCHEME	LAUNCH DATE	NFO COLLECTION (₹ CR)
Mirae Asset Healthcare	2 Jul 2018	206.27
ICICI Pru Pharma Healthcare & Diagnostics (P.H.D)	13 Jul 2018	1,198.62
DSP Healthcare	30 Nov 2018	157.69
Aditya Birla SL Pharma & Healthcare	10 Jul 2019	150.86

SOURCE: Value Research, ACE MF; Compiled by ETIG Database

Methodology used for the study

In order to assess whether investors should invest in or avoid NFOs, we studied historical data and the performance of open-ended equity NFOs over the past five years. To weed out very small NFOs from the study, we kept a minimum threshold of ₹100 crore for the starting AUM. The first year's performance of these NFOs were compared with the category average, best performing scheme, worst performing scheme and the scheme with highest AUM. We stuck to one year performance as these NFOs were launched at different points of time over the past five years. Thus comparing for all five years would not be correct. It would amount to comparing the three year performance of one scheme with a year's performance of another scheme. Since close-ended NFOs are plagued by other problems (*see box*), the same is not covered by this study. NFOs are mostly pushed by distributors and therefore, regular plan returns have been considered for this analysis. Since index funds only carry timing risks and not fund management risks, only actively managed funds were considered for this analysis.