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Sector Funds v/s Diversified Funds

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Diversified funds have significantly lower downside risks than sector funds, as the former invest across a range of sectors, says ***T Srikanth Bhagavat, MD, Hexagon Capital Advisors***

Q) Six months ago, I invested in Franklin India Bluechip Fund, DSP Blackrock Equity Fund and HDFC Equity. I have read that banking stocks have done better than these funds. Please help me decide whether I should also invest in a banking fund to grow my money faster?

- Gaurang Satarkar

Over the last six months, your investments in diversified funds would have generated returns between 15 per cent and 17 per cent. Over the same period, the BSE Bankex has generated returns of 21 per cent, and has outperformed the Sensex and broad-based equity funds. Banking sector funds have also generated higher returns than their diversified counterparts over this period.

Scheme Name	Absolute Returns (Months)			CAGR (Years)		
	1	3	6	1	3	5
Scheme Performance As On January 15, 2013						
Diversified Large & Multi-Cap Funds						
DSPBR Equity Fund(G)	3.09	8.99	17.28	27.11	6.41	3.88
Franklin India Bluechip Fund(G)	4.81	9.53	16.42	24.58	8.77	5.37
HDFC Equity Fund(G)	4.83	8.56	16.97	29.71	8.68	6.62
Sector Funds						
GS Bank BeES	3.41	12.19	21	43.31	13.63	5.05
ICICI Pru Banking & Fin Serv Fund(G)	4.21	16.3	30.42	57.19	17.38	-
R* Shares Banking ETF	3.4	12.26	21.06	44.04	14.02	-
Reliance Banking Fund(G)	5.85	16.02	26.49	50.19	18.15	12.52

Scheme Name	Absolute Returns (Months)			CAGR (Years)		
	1	3	6	1	3	5
Scheme Performance As On January 15, 2013						
Religare Banking Fund-Reg(G)	3.77	13.01	25.08	46.28	16.41	-
Sundaram-Select Thematic-Fin Serv Oppor(G)	5.42	14.28	21.69	37.19	11.04	-
UTI Banking Sector Fund(G)	4.32	13.32	21.74	44.38	14.94	6.48
Indices						
BSE BANKEX	3.47	12.36	21.15	42.87	14.14	3.78
BSE SENSEX	3.47	6.8	16.11	23.51	4.42	-0.26

Scheme Name	1 Yr	3 Yrs	5 Yrs
Downside Risk As On January 15, 2013			
Diversified Large & Multi-Cap Funds			
DSPBR Equity Fund(G)	2.02	5.25	11.32
Franklin India Bluechip Fund(G)	2.01	4.4	10.87
HDFC Equity Fund(G)	2.33	5.4	12.14
Sector Funds			
GS Bank BeES	3.32	7.51	15.65
ICICI Pru Banking & Fin Serv Fund(G)	2.46	7.02	-
R* Shares Banking ETF	3.14	7.36	-
Reliance Banking Fund(G)	3.14	7.42	12.83
Religare Banking Fund-Reg(G)	2.85	7.16	-
Sundaram-Select Thematic-Fin Serv Oppor(G)	4.15	8.16	-
UTI Banking Sector Fund(G)	3.58	7.58	14.27

However, in the long-run, you would be better off investing the majority of your corpus in diversified funds rather than in sector-specific funds. First, banking stocks are cyclical and rate-sensitive. The sector is linked to the overall performance of the economy. Banking funds may generate high returns if the economy recovers. Conversely, a recession may drag down the returns of banking sector funds more than the returns of diversified funds.

Secondly, diversified funds have significantly lower downside risks. Sector funds are subject to concentration risks – the fund's returns may suffer if the sector does badly. In contrast, a diversified fund invests in a variety of sectors. Thus, even if a single sector fares badly, the fund's returns may not be as severely affected as other sectors in the portfolio may outperform. As a matter of fact, in diversified funds, most fund managers continuously rebalance their portfolios and are overweight on sectors expected to outperform and underweight on poorly performing sectors. However, the fund manager of a banking fund has to invest the majority of the corpus in banking stocks even if the outlook for the sector is bleak.

Currently, the diversified funds in your portfolio have invested in banking and financial stocks. However, their portfolios also have funds across other sectors. Therefore, by investing in diversified funds, you will benefit if the underlying economy does well and banking stocks rally. Even in the event that there is a recession and banking stocks fall, your returns will not be significantly eroded. This is because the funds in your portfolio also have some exposure to defensive or non-cyclical sectors such as FMCG and Healthcare.

Top Sector Holdings As On December 31, 2012					
DSPBR Equity		**Franklin India Bluechip**		**HDFC Equity**	
Sectors	**% Holding**	**Sectors**	**% Holding**	**Sectors**	**% Holding**
Financials	**29.6**	**Financials**	**23.9**	**Financials**	**27.2**
Energy	9.8	Energy	17.6	Energy	14.9
Services	9.3	Technology	9.4	FMCG	9.5
Automobile	8.5	Healthcare	8.2	Technology	8.4
FMCG	7.6	Communication	7	Automobile	7.6
Technology	5.6	Metals	6.4	Services	5.9
Textiles	4.4	Automobile	4.2	Healthcare	5.7
Healthcare	4.2	Engineering	4.1	Metals	5.3
Construction	4.1	FMCG	3.6	Engineering	2.5
Chemicals	2.1	Chemicals	1.3	Communication	1.4

In conclusion, you need to have high risk tolerance and a longer time horizon to invest in sector-specific funds. With reference to your current portfolio, a banking sector fund may not add value as the funds you have invested in already have exposure to banking and financials stocks.

To maximise your returns, you may want to allocate a small percentage of your portfolio to small and mid-cap funds. These funds have the potential to outperform large and multi-cap funds. However, remember that small and mid-cap funds are generally more volatile.