With more than 650 mutual funds in the country, and the estimated size of the industry at more than 2.58 lakh crores, Mutual funds are fast becoming one of the most preferred investment avenues in the country. This has actually led to a problem! The investor is now spoilt with choice and is bound to get confused where to put in his / her hard earned money. Which of these funds are ‘safe’ but still can give the best of returns.

Well, in our previous issue (April 2006) of The Wise Investor, we had written about the Offer Document, which highlights the investment strategy, the associated risks, the management style, the fund manager and his credentials, the fees and expenses etc., which are qualitative in nature.

When it comes to quantitative information, the investor is forced to look at past performance, though it is no indicator of the performance to come. Hence, it becomes very important for the investor to look at past performances of various mutual funds across different parameters in taking an informed decision.

With this background, a few questions – however unpleasant – needs to be asked.

• The most common way of looking at past performance is only the returns. Is this correct?
• Should you invest in a fund with spectacular returns (albeit in the recent past) just on the basis of the returns?
• What are the risks associated with the fund? Is there any way of measuring it?
• If returns are not the only parameter, what else should you look for?
• How predictable is the fund based on the past performance. Is there a pattern emerging?

Risks associated with a fund
Risk associated with a fund, could be defined based on the fluctuations of the returns generated by it. The higher the fluctuations in the returns, in a given period, higher the risks associated with it. These fluctuations are resultant of two forces:

a. General market fluctuations, which affects all the stocks in the market & can be called market risk or systematic risk.

b. Risks associated with the stocks in the portfolio of the fund in discussion or unsystematic risk.

This would mean that a fund manager could reduce the unsystematic risk by diversifying the investments. Systematic risk, on the other hand, cannot be reduced and is dependent on macro-economic factors. By using the risk return relationship, we try to assess the competitive strength of the mutual funds vis-à-vis one another in a better way. We will now see a few measures of risks and how these measures can help you in choosing the fund that would suit you best.

Measures of Risk

Beta
Systematic risk is measured in terms of Beta, which represents fluctuations in the NAV of the fund vis-à-vis market. This is the relationship between the volatility in the fund’s returns as compared to those of the market benchmark. The value of Beta for the benchmark is 1. A fund with a value of Beta greater than 1 is more volatile than the benchmark, and a fund with a value of Beta less than 1 is less volatile than the benchmark. A value close to 1 indicates that the fund is closely following the benchmark.

Sharpe Ratio
This ratio measures the amount of excess return for each unit of risk taken by the fund. Excess return is measured as the difference in return generated by the fund and the return generated by the risk free rate of interest. A negative excess return indicates that the fund is generating less return than the risk free rate. A more volatile fund with returns changing rapidly will have a higher standard deviation and therefore higher risk. The Sharpe ratio is a performance ratio, and therefore when a fund is compared to others in this category, a higher Sharpe ratio indicates that the fund is generating more returns for each unit of risk it has taken, as compared to other funds in its category. A negative Sharpe ratio does not make any intuitive sense, however equity funds often show these due to higher volatility. Therefore a Sharpe ratio should always be used as a measure of comparison between similar funds.

Treynor Ratio
Another comparison ratio, which measures the excess returns a fund generates for each unit of market risk it takes. The excess return is calculated as in the Sharpe ratio, while the market risk is taken as the Beta of the fund. This ratio is a better measure of performance for equity funds as it takes into account market volatility. Again, it should be used to compare funds in the same category, and in any such category a higher Treynor ratio is better than a lower ratio, as this means that the fund is better at generating returns and is not too volatile.

Comparison of Sharpe and Treynor ratios
Sharpe and Treynor ratios are similar in a way since they both are a measure of the excess returns a fund generates for the risk taken. For a well-diversified portfolio, the total risk should be equal to the systematic risk. Hence for a well-diversified portfolio, the Sharpe ratio & the Treynor ratio should be identical. Therefore, a fund that has a high Treynor measure & is poorly diversified would rank low on the Sharpe ratio.

Information Ratio
This is a way to see, whether a fund manager, who has taken risks that are greater than the market-risk (which is unavoidable), has acted upon good ‘information’, i.e. whether he is generating returns that more than make up for taking that additional risk. It is measured by using the differential returns of the fund as compared to the benchmark. A higher information ratio indicates that the extra risk being taken is being managed more than adequately to generate extra rewards for the fund.

With these above measures, which are generally available in most independent tracking agencies (Value Research, Mutual Funds India etc.) or with the fund houses themselves, an investor would be armed well enough in taking a decision which most probably not lead to any regrets. These measures help individual investors like you in taking decisions based on your risk appetite and returns expectations.

Happy investing!