In the previous issue of The Wise Investor, I had shared some perspectives with you on what risk means for us investors; specifically, I had illustrated how risk can be used to boost longer-term returns, contrary to the popular perception that "Risk= Losing Money". I had, in fact, proposed that these risks be spelt differently (‘Riske’) to distinguish them from other risks, that can, in fact lose you money.

In this article, I would like to focus on two areas:
• Techniques to control ‘riske’ and to use riske to boost longer-term returns
• Identifying and controlling ‘risk’- the variety which, unlike “riske” is not an investor’s friend, but a foe

Ways to use ‘Riske’ to come out ahead:
This topic may be all the more relevant today, given the fluctuations of the stock market over the last two months in response to the unfolding political drama. Remember, these fluctuations are shared by all participants in the market, and can thus come under the general classification of ‘riske’. In such situations, the long-term investors must keep reminding themselves that this is not the time to exit the market, as instinct may dictate, but to actually invest more- provided, of course, that the outlook for corporate India’s prospects look bright.

The temptation is always there to ‘wait and watch’, typically embodied in sentiments like, “Let’s wait for the market to move up in response to what we know are good prospects for Indian companies, and we’ll then invest”.

But consider this. In 2003, markets started moving up in April. If you had remained invested in the NSE Nifty from April 2003 till March 2004, would have obtained a return of 80.02%.

But, if, like many ‘savvy’ investors, you saw markets begin to move up and kept telling yourself, “It’s gone up too much now, let it correct, and I’ll invest”, and thus ended up investing only on 23rd September 2003, the day after a correction, your annualized returns to March 2004 would have been 74% (absolute returns of 33.4%). If you had seized the first opportunity (which most did not, as the correction was ‘smaller’), and invested on 23rd July 2003, then your annualized return would have been 94.6% (absolute return of 58.3%). Clearly the magnitude of the correction does not influence the returns that can be obtained.

Indeed, in the course of our interaction with many investors, we saw this phenomenon happen time after time. These investors treated riske as a foe, and thus did not benefit from the power such risks could add to long-term returns, and ended up with lower returns in their attempt to time the market.

**Movement of the NIFTY from April 2003 - March 2004**

Source: www.nseindia.com
A “Wait and Watch” strategy may not yield better returns.

Avoid the temptation to review investments every time the market moves up or down.

Systematic investment plans can help avoid the trap of second guessing market trends.

Funds can be divided into three broad styles Passive, Active-Diversified and Active-Concentrated. The style determines the risk for each fund.

Before investing check whether
- Your diversified fund has out-performed its benchmark consistently.
- The stock exposure levels of the diversified fund
- Track record of the concentrated fund
- Performance of the concentrated fund during market downturns and upswings

This is also borne out by a study the investment analysts at Sundaram Mutual had undertaken, using the BSE Sensex between April 1985 and March 2002. An investor who had stayed invested in the Sensex through this 17-year period would have obtained a return of 16.39% p.a. However, the investor who, in an attempt to time entry and exit, missed the best 10 days of the market in this 17 year period, would have seen his returns reduce to 9.65% p.a. And if the investor had missed the best 40 days in this period, his returns would have been 0.51% p.a., implying he would have been better off keeping his investment under his pillow!

So how do we, as investors, avoid the temptation to ‘time’ the market? There are two ways of doing this:
- Make a one-time investment over a longer time horizon, and avoid the temptation to keep reviewing it every time the market moves up or down; after all, even people who invested in 1999 have seen their investment, which kept going down steadily till 2003, yield something around 8% p.a. in 2004!
- Invest systematically, in a disciplined manner, trying to avoid second-guessing the market. Systematic Investment Plans (SIP) are a good way of doing this (SIPs were covered in detail in the previous issue of The Wise Investor)

Identifying and controlling ‘risk’:
I would now like to focus on the traditional ‘risks’, which can lose you money, unless you control them. These risks are more to do with the style in which your money is managed. If we were to look at equity funds, there are three broad styles in which your money can be managed (there are a variety of thematic styles also-e.g. funds that invest only in midcap segment, but the styles listed below would be the broadest possible classification):
- Passive
  This style attempts only to expose you to the fluctuations of the market (‘riske’) and not to the individual decisions of the fund manager (which may include a component of ‘riske’, as well as ‘risk!’)
- Active-Diversified
  This style attempts to allow the fund manager to deviate to a controlled extent from the market, with the objective of adding value to market returns, e.g. Sundaram Growth Fund.
- Active-Concentrated
  This style allows the fund manager much more liberty to deviate from the market; if the calls go right the returns are very much above market, and vice versa! e.g. Sundaram Select Focus.

While passive funds, and to a large extent, diversified funds expose you to more of ‘riske’, the concentrated fund can have a higher element of ‘risk’. So how do you control this, and make your investment portfolio work for you? Here is a small checklist of things to understand about your equity fund, that I have found useful in my investing:
- Has your diversified fund consistently out-performed it’s benchmark over various time periods? If so, the deviations of the fund manager are beneficial to you, taken as an average.
- Is your diversified fund really diversified? What are the stock exposure and sector exposure policies that control deviation from the market?
- If you are investing in a concentrated fund:
  - What is the track record of the fund- a fund that compensates you by delivering superior returns in exchange for the unpredictability brought about by large deviations from the market is to be preferred
  - If possible, get your advisor to isolate the performance of the fund during market upswings and down-turns. Be comfortable with the decline during downturns before investing, and give the fund an appropriate weight in your investment portfolio

The best starting point to get this information would be the monthly fund fact sheet, as well as the offer document of the fund in question. Please read the section in this newsletter titled “Demystifying the equity fund fact sheet” for more details.