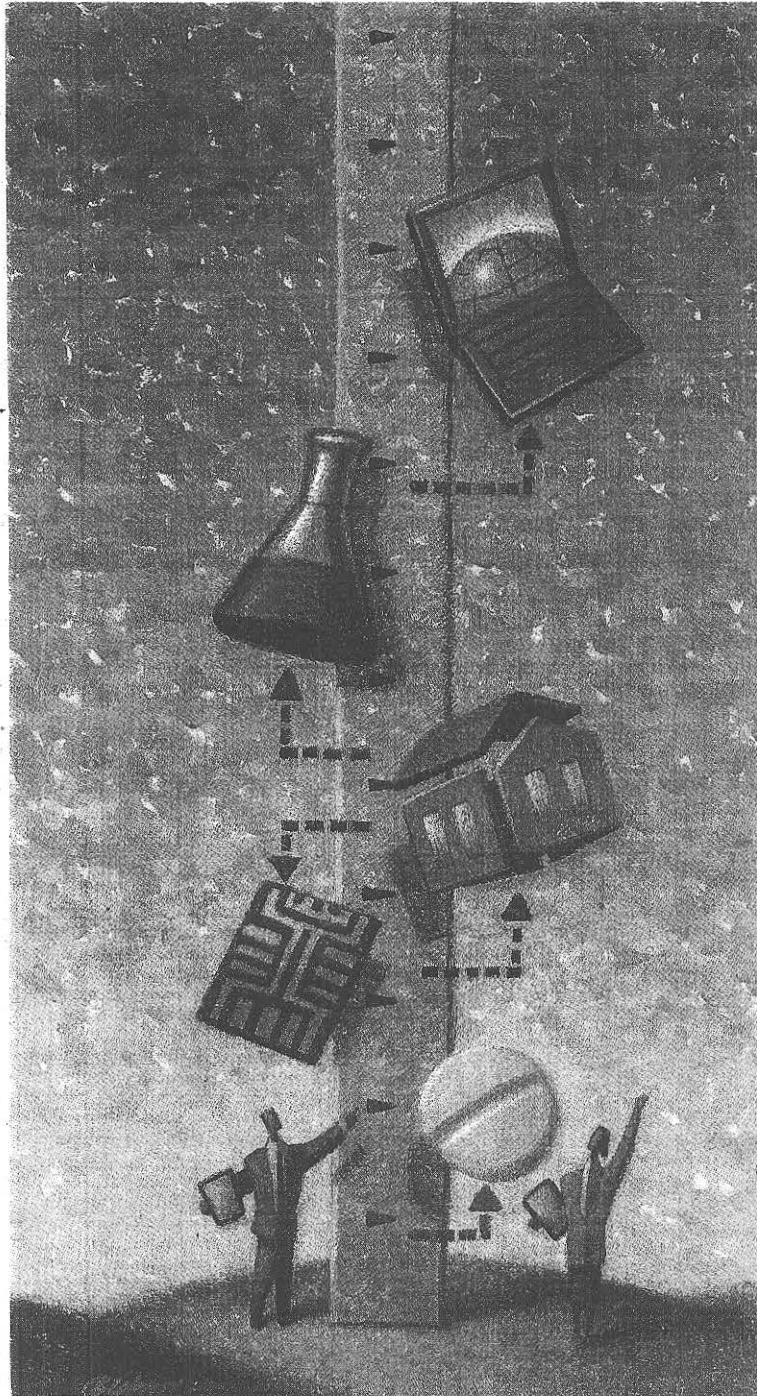


INVESTING

# Are sectoral funds for you?

Though some sectoral funds have given better returns than the equity diversified funds in the past few years, don't invest blindly in them. Here are the things you should consider before picking up one.

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SHOBHANA CHADHA

It's a common advice for the average investor: keep away from sectoral funds unless you know the industry and can track it well. For, not only are you likely to amass huge losses if you cannot keep abreast of business cycles, but also expose your portfolio to the concentrated risk that comes from investing in sectoral funds. If, however, you are an informed investor and can assess the volatility associated with such funds, you can make a neat profit.

This would be true if you were to consider the recent performance of sectoral funds. The funds have taken the top three spots when it comes to generating returns not only in the past one year but also in the three- and five-year periods. The average returns delivered by funds belonging to sectors such as pharmaceuticals, fast-moving consumer goods (FMCG), banking, and information technology (IT) have consistently beaten the average returns of the diversified equity funds.

In fact, for some sectoral funds, even the standard deviation, which is a measure of volatility, has been lower than that of the diversified fund category over the past five years. For instance, the average five-year standard deviation for pharma funds is 1.26 and that for FMCG funds is 1.39, while that for large-cap diversified equity funds is 1.7. The higher the standard deviation, the higher the volatility, and vice versa.

However, it's not just returns and volatility that one should consider while investing in sectoral funds. Experts warn against drawing a generic picture about the performance of sectoral funds. "One cannot generalise that sectoral funds outperform the market. The key is to be in the right sectors at the right time to benefit from the outperformance," says Maneesh Kumar, MD, Burgeon Wealth

Advisors. So even though the top performing sectoral funds have done better than the equity diversified funds in the one-year and three-year time periods, there are several other sector-specific funds that have not fared as well in the same period. For instance, most funds from the infrastructure sector have not performed better than the equity diversified funds. Barring the DSP BR Natural Resources and New Energy Fund, almost all energy funds delivered negative returns in the one-year and three-year time frames. The same holds true for funds in the media and entertainment sector. Here are some things that you should keep in mind before you decide to invest in a sectoral fund: **Not for new, uninformed investors:** Most experts believe that sectoral funds should not be picked by new investors or those who have little time, domain experience or knowledge. "In the case of sectoral funds, the investor typically takes on the role of managing sector allocation, which is typically played by the fund manager in the case of a diversified fund," says Vetri Subramaniam, head of equity funds, Religare Mutual Fund. So, unless you are active, informed and have a lot of time on your hands, avoid these. "The investors who are new to equities should not even look at sectoral funds. Comfort is more important than conviction in the arena of investing," says Vikaas Sachdeva, CEO, Edelweiss Mutual Fund.

Sectoral funds should be chosen as an investment instrument only if the investor is comfortable with the growth potential in a particular sector. Such comfort requires domain knowledge, which can only be developed over time through experience and research in the specific sector.

However, if an investor is closely working with a competent wealth manager, who has the ability to manage the sector

## Performance of sectoral funds versus equity diversified funds

Category	1-yr return	3-yr SD	3-yr return	3-yr SD	5-yr return	5-yr SD
Equity div-large cap	8.71%	1.01	9.25%	1.66	10.57%	1.70
Equity div-mid cap	6.62%	1.05	8.83%	1.63	8.22%	1.69
Equity FMCG	25.21%	0.88	18.88%	1.09	11.82%	1.26
Equity Infotech	18.67%	1.11	12.54%	1.69	9.31%	1.73
Equity Pharma	13.31%	0.77	26.10%	1.23	12.41%	1.39
Equity Banking	25.54%	1.36	25.80%	2.04	25.50%	2.01

As on 7 Apr 2011. SD is standard deviation. The higher the standard deviation, the greater the volatility, and vice versa. Data source: NAV India

allocation for him, he can certainly take this route. "The investor is new, but the adviser is seasoned. The risk element is higher, but the sectoral fund will provide alpha returns if the industry is growing more than average," says Avinash Nahata, head of fundamental desk, Aditya Birla Money. **Invest for the short term:** One should ideally invest in sector-based equity funds for a relatively short period of three to five years. This is because such funds tend to be cyclical in nature and are likely to do well under market conditions that work in the sector's favour. "One must remember that over a long term of 10 years or more, returns from these funds even out and cannot match the performance of diversified equity funds. They follow business cycles and, hence, are slow movers," says Rajnish Kumar, executive vice-president, Fullerton Securities.

**However, if the sectors are not cyclical in nature, experts believe that one does not need to book profits on a regular basis. This means that one can overcome the time impediment of investing in sectoral funds. The sectors that are not cyclical include FMCG, pharmaceuticals, IT, among others. "Investors should closely watch the factors affecting the sector to determine the period of investing rather than having a predetermined notion on it. As long as the reasons for bullishness towards the sector remain intact, there is no reason to book profits," says Maneesh Kumar.**

**For instance, the telecom sector was considered favourable between 2000 and 2008 and one could have considered investment in it for a longer period of time. The cost of acquisition was low, the average revenue per user was rising, competition was less and the regulatory environment was favourable and transparent. However, when regulations changed and competition came in, it was more prudent to exit the sector and book profits.**

**Invest only to diversify:** Sectoral funds should not form the core of your portfolio. No matter how lucrative the returns from such concentrated stakes, they cannot reduce the significance of diversification. "We recommend sectoral funds as a top-up to an investor's holding of diversified equity funds," says Subramaniam. According to

financial experts, an investor can allocate 10-20% of his total equity allocation to these funds.

At the same time, diversified equity funds cannot serve as a substitute to sectoral funds even if they have an exposure to the sector in which you have a positive outlook. "A sector fund manager is more likely to conduct an in-depth research across companies of different sizes and provide better investment opportunities in a sector compared with a diversified fund. Also, a diversified equity fund manager could move out of the sector for some other opportunities," says Rajnish Kumar.

Overall, an investor should ensure that the fund he chooses sticks to the mandate of being a sector-oriented fund and has a good track record. Another thing to keep in mind while investing in sectoral funds is that one should avoid over-exposure and ensure that one doesn't invest in sectors where the rally is peaking. "If the PE ratio for the sector is above 20, it should serve as a warning that the surge is inching towards an end," says Sachdeva.

**Sectors to consider:** Not all sectors are worth taking the concentrated risk. Given the current market dynamics, experts are betting on pharmaceuticals in the short as well as the long term. "There is a huge growth opportunity in pharma both on the domestic and international front in the generic and the branded generic space," says Nahata. An increase in spending in healthcare by the government has ensured a robust domestic demand for the sector and it should continue to do well due to a further hike in allocation this year.

The other sector which is being seen as promising in the short as well as the long term is banking. The sector tends to perform well when there is an overall growth in the economy, which is expected to be the case with India in the coming years. Though liquidity has remained tight, credit growth is likely to remain buoyant in the next financial year and, hence, will ensure low cost of funds. "A rise in bad loan recoveries will ensure better asset quality and a greater penetration in tier 3 and 4 cities over time will add momentum to the growth of the banking sector," says Rajnish Kumar.

**Don't invest immediately:** There is no need

## Sectoral funds have given good returns over different time periods



CHANDER

to rush into investing in sectoral funds, even the ones which show promise and are being recommended by analysts. These include IT, infrastructure and FMCG. While these sectors are genuinely good avenues to park your funds in the long term, there are some doubts regarding these in the near term.

**The FMCG sector is suffering from inflation woes. "Companies are facing a fall in pricing power. There is also a decrease**

**in perception of the FMCG being a safe haven in volatile times. Once input costs decrease and pricing power returns, one can take a re-look at this sector," says Maneesh Kumar.**

As far as information technology is concerned, the adverse currency movements and negative rhetoric on outsourcing from the West pose potential concern and may give jitters to the sector. "However, the IT outsourcing is moving up the value curve and is likely to get bigger. Knowledge outsourcing will be the key driver," says Nahata.

**The massive correction in the stocks of the infrastructure sector has made the valuations attractive. However, even as the order books of infrastructure companies are looking strong, the sector is currently facing a rough time and needs to accelerate the execution of pending projects. "An investor with an aggressive risk profile can take a bet on this sector at this juncture. It's slightly early to be investing in this sector, but if he's willing to wait, he can reap very handsome rewards in the long term," says Maneesh Kumar.**

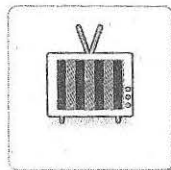
The bottom line? If you have domain knowledge or can avail of the services of a competent wealth manager, do invest in sectoral funds. If you choose the sectors carefully, avoid over-exposure, and know when to exit, you are bound to make a good profit.

## Why you should invest in these sectors?



### PHARMA

Indian pharmaceuticals remain robust and experts hold a positive view on the sector. One can invest in it for an extended period of time. Massive demand, supply shortages, strategic tie-ups, licencing deals and exclusive product launches could result in incremental profitability. An increase in healthcare spending by the government will also act as a boost for the sector.



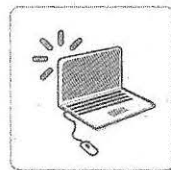
### FMCG

Experts are not recommending investing in this sector in the short term. This is because the input cost inflation remains a key concern in the near term. However, revenue growth can see a boost in the next few quarters due to the price hikes executed in select categories. Urban demand is already showing signs of improvement; a good monsoon could improve rural demand as well.



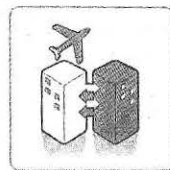
### BANKING

A majority of experts hold a positive view on the sector. A healthy outlook on the GDP and strong credit take-off (targeted at 20% by the RBI) are encouraging. Besides, real interest rates have entered positive territory, which will drive deposit growth. A hike in lending rates will reduce the impact of higher cost of funds during 2010-11 and help maintain a net interest margin.



### INFO-TECH

Experts are neutral in the short term and bullish in the long term about this sector. Currency fluctuation is a key risk for the industry, but companies mostly hedge themselves against it. Demand seems to be robust as firms continue to increase their order books. The top tier Indian IT vendors have the highest exposure to BFSI, which has been the primary growth driver.



### INFRASTRUCTURE

The short-term outlook is neutral. The sector has corrected significantly, but concerns over rising inflation, unfavourable interest rate scenario, and delay in order approvals from government and meaningful land acquisition reforms remain. Experts see the sector generating significant wealth for investors in the long term as investment in it by the government and via the PPP model is inevitable.



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