Diversify your portfolio to include value funds

But do not exit from growth-style funds as they may benefit next from a shift in investor preference

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One category that has done relatively well in the past year, when most categories of equity funds have fared poorly, is value funds. This category, which has 19 funds with assets under management of ₹73,524.4 crore, has earned an average return of 14.2 per cent via the systematic investment plan (SIP) route over the past year.

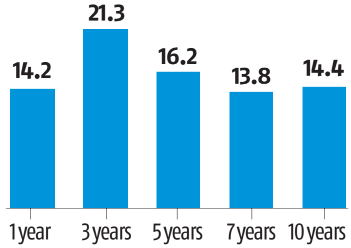
Buying at discounted prices

Growth-oriented funds invest in stocks whose earnings per share (EPS) are growing at a fast pace. Value funds, on the other hand, invest in stocks of companies that have the ability to sustain their earnings growth but whose valuations are temporarily suppressed due to a short-term company or industry-related issue.

According to S Naren, executive director and chief investment officer, ICICI Prudential Mutual Fund, "ICICI Prudential Value Discovery Fund typically invests in companies with high potential that are quoting at a discount to their fair or intrinsic value."

Says Anand Radhakrishnan, managing director and chief investment officer, emerging markets equity-India, Franklin Templeton: "Our value fund selects stocks based on the following criteria: cheap absolute valuation vis-à-vis broad market opportunities; relatively valuable compared to sector peers; valuable compared to its own past valuations; turnaround in business; and undiscovered value coming from subsidiaries or associate companies."

CREATING VALUE FOR INVESTORS (Returns in %)



Source: Morningstar AWS

Value style gained favour

One reason for value funds' outperformance in 2022 was that they had underperformed in 2018 and 2019. Their performance turned around from 2020 onwards.

"Valuations of many sectors had become compressed due to the slow pace of economic growth and consumption. The scenario worsened during the first wave of Covid-19. However, as the scenario improved, many of the compressed segments of the market made a comeback. Funds with a value-conscious investment approach, which had invested in such segments, gained," says Himanshu Srivastava, senior analyst, manager research, Morningstar.

This shift in preference was global. "India was part of a global trend of value stocks being favoured over growth," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisers.

Sectors like financial services and energy, which value funds had exposure to, did well. "Stocks of large-cap banks outperformed due to improvement in credit offtake and asset quality. Utility and energy stocks rallied against the backdrop of ongoing geopolitical tension," says Radhakrishnan.

Adds Naren: "Going overweight on sectors like energy, healthcare and communication worked well for our fund over the past year."

Beware of value traps

One risk of investing in value funds is that the fund manager may invest in a value trap. "These are stocks whose valuations have been suppressed by the market, not because of temporary factors but because their long-term prospects are also poor. If the investment team doesn't do proper due diligence, it can end up investing in such value traps," says Dhawan.

Be prepared for periods of underperformance in these funds. "In periods such as 2006 to 2008, 2017-18 to September 2020, the value style of investing was out of favour," says Naren. According to him, only an investor who stays invested during such phases will experience long-term wealth creation.

Go for a mix of styles

Besides diversifying by market caps, also diversify your portfolio by investment styles. If it has growth-style funds, don't exit them due to their current underperformance. Instead, take exposure to value-style funds as well. It is impossible to predict which style will outperform at what point of time. "When one style goes out of favour, the other one will make up for it and keep your portfolio afloat," says Srivastava.

Diversifying also helps avoid timing risk. Says Dhawan: "Having exposure to both value and growth styles means you don't have to time your entry and exit from these styles, which is anyway impossible to pull off consistently."

Check a fund's style box to know whether it is a value or growth style fund.

Dhawan suggests that when selecting a value fund, compare rolling returns, rather than point-to-point returns of funds, as the former captures performance consistency better. Besides active funds, you can also take exposure to the value style via a smart-beta fund. Finally, pay attention to expense ratio while selecting a fund.