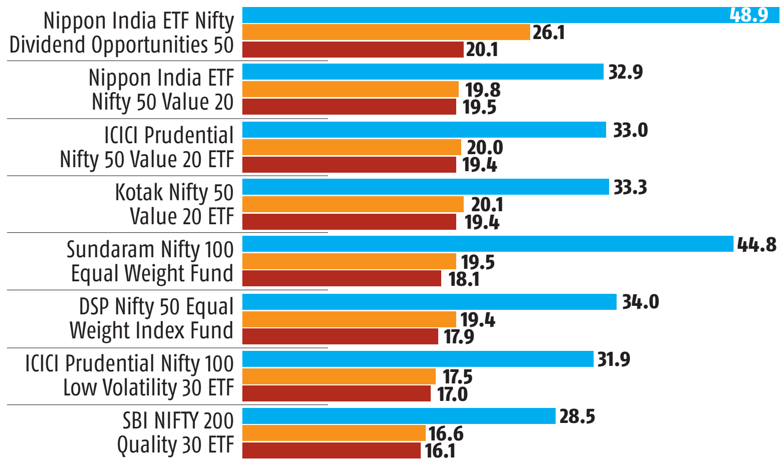
Select a smart-beta fund based on your risk tolerance

Aggressive investors may choose momentum-based factor funds

SARBAJEET K SEN

ROBUST PERFORMANCE OVER FIVE YEARS

Fund returns ■ 1 year ■ 3 years ■ 5 years (%)



Only funds having a five-year track record included. Returns above one year are in CAGR.
Returns are of growth, regular plans in case of funds; Data as on May 8

Source: Navigation RA

Investors seeking alpha — returns in excess of those offered by benchmark indices — face challenges in identifying consistent performers among active fund managers. Their higher cost is another issue. Smart-beta funds, which share some features of both active and passive funds, partly address these issues. Recent additions to the growing list of smart-beta funds include Edelweiss Nifty Alpha Low Volatility 30 Index Fund, Mirae Asset Nifty MidSmallcap400 Momentum Quality 100 ETF and Mirae Asset Nifty MidSmallcap400 Momentum Quality 100 ETF Fund of Fund.

What is a smart-beta fund?

Passive equity funds track the performance of indices such as the Nifty 50 and Nifty Bank, which are constructed on the basis of market capitalisation. Smart-beta schemes track equity indices constructed on the basis of a factor: value, quality, momentum, alpha, volatility or growth. The index manufacturers pick stocks that score high on one or more of these factors to build these indices.

YOUR MONEY

Eliminate fund manager risk

The index construction methodology using quantitative rules is clearly defined here. "In a smart-beta offering, factors are the building blocks. There is no element of human bias. It is completely rule-based. They are passively managed and replicate the performance of a specific index. They tend to have lower expense ratios. They provide solutions in a transparent and cost-effective manner with the potential for enhanced returns," says Chintan Haria, principal investment strategy, ICICI Prudential Asset Management Company (AMC).

Good for diversification

Smart-beta funds can effectively diversify your portfolio. Many low-quality stocks may enter the portfolio to benefit from rising prices. A systematic investment plan (SIP) in a smart-beta fund tracking the Nifty 100 Quality 30 index can provide effective diversification. "If an actively managed portfolio is heavily tilted towards a certain style of investing, the investor can consider investing in a smart-beta fund of a different style to act as a counterbalance and negate style-oriented risks," says Haria.

Performance can be uneven

Any factor does not perform across all time periods. "Different factors do well in different market conditions," says Vishal Dhawan, founder and chief executive officer (CEO), Plan Ahead Wealth Advisors. He adds that these indices are constructed based on historical data, but the market could behave differently in the future.

Multi-factor funds: Smoother ride

While these are index funds, they are not simple products (like market cap index-based funds). Investors need to understand the methodology of how their indices have been constructed. They should also examine their performance across market cycles.

Single-factor funds can underperform in certain market environments. "While smart-beta factors carry the risk of underperforming the market during specific periods, this risk can be mitigated by incorporating two or more factors simultaneously," says Niranjan Avasthi, senior vice president (SVP) and head–product, marketing & digital business, Edelweiss Mutual Fund (MF).

Investors should choose a fund that matches their risk profile. "Aggressive investors could explore momentum-based factor funds, as long as they are comfortable with the potential higher downside when the market corrects. Moderate risk takers may prefer a fund based on the low-volatility index or quality index," says Dhawan.

Restrict exposure

Restrict exposure to these schemes to 20 per cent of the portfolio. "Start with a smaller allocation of around 5-10 per cent and gradually increase exposure as you gain confidence," says Avasthi.

Use the SIP route to invest in these schemes and invest with a long-term view to tackle underperformance risk.