Defence mutual funds down over 15% since last Budget. All eyes on Feb 1 announcements

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With defence mutual funds losing over 15% since the last Budget announcement made on 23rd July 2024, the market expert believes that the government's focus in this budget will be to improve consumption rather than capex. Also, India's defence spending in the last 10 years has increased at a rapid pace compared to global average so investors may wait for valuation to come down, he adds.

"Currently in India consumption is showing a downtrend, so the government's focus during the budget is likely to be more on improving consumption. The Ministry of Defence recently announced a Rs 21,700 crore work clearance, emphasizing its commitment to reform and modernization. The focus is on capability building in areas such as robotics, AI, training, and simulation, alongside fast-tracking key projects. Trump is expected to strengthen military capabilities through procurement or strategic alliances," said Vishal Dhawan, CEO, Plan Ahead Wealth Advisors, a wealth management firm in Mumbai.

"India's defense spending in the last 10 years has increased at a rapid pace (10%) than the global average (3%). Investors may want to wait for more valuation comfort before they allocate funds, and when the valuations are more reasonable, have a long term investment horizon," he adds.

Two funds based on the defence sector were there in the mentioned period. Of which Motilal Oswal Nifty India Defence Index Fund lost the most of around 15.35% since the last Budget announcement. HDFC Defence Fund lost 12.19% during the same period. These schemes are benchmarked against Nifty India Defence - TRI which went down by 14.72% since the last budget announcement.

The two passive funds were launched in August 2024. Motilal Oswal Nifty India Defence ETF and Aditya Birla SL Nifty India Defence Index Fund were down by 10.02% and 9.30% respectively since their inception.

According to the expert, over the past few months, valuation compression in the defence index has resulted in negative returns and the Nifty India Defence Index saw substantial gains in the CY23 and first half of CY2024.

A small universe of companies limits opportunities to find undervalued stocks in this sector and diversify effectively which also limits the ability to protect downside risk. This led to profit booking, as investors capitalized on the sharp returns within a short time frame, which resulted in a correction in the second half of the year, he adds.

In the first half of 2024, only HDFC Defence Fund was available for investment, and it went up by 53.05% in the same period. The fund discontinued lumpsum subscriptions and imposed restrictions on systematic transactions from 22nd July 2024.

According to an earlier report by ET MutualFunds, HDFC Defence Fund offered an absolute return of 145% since its inception just before the restrictions on fresh investments kicked in.

After the stellar performance by the fund, many investors made investments in the new funds launched and in HDFC Defence Fund before the restrictions were imposed. Now the funds based on the defence sector are offering negative returns, therefore the expert advises that investors should continue to hold their investments as the long-term outlook for the sector remains positive.

“The long-term outlook for the defense sector remains positive, supported by increasing government spending and strategic initiatives. Global geopolitical tensions and India’s rising focus on self-reliance are fuelling order flow and revenue growth for domestic Defence companies,” said Dhawan.

“A robust order book could drive revenue growth. By mandating higher procurement from local suppliers, the share of domestic procurement has increased from 55% in 2019 to 75%, with further growth expected in the coming years. However, it is important to keep in mind that high volatility could be encountered along this journey,” he added.

He further adds that defense projects have long execution cycles (5–10 years), making it difficult to predict future earnings from current order books. Revenue recognition is spread over multiple years, often causing a mismatch between order size and immediate profitability. Therefore, it's crucial to closely monitor upcoming results. Despite the recent decline in the Defence Index, its trailing P/E is still nearly double that of the Nifty 500, indicating that valuation comfort remains lacking. So, if an investor is already invested, it's better to stay invested. However, if you're looking to allocate now, it’s advisable to wait for more valuation comfort.