

Defence mutual funds surge up to 25% in a month. Should you invest now or wait for a correction?

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With defence sector based mutual funds offering up to 25% return in the last one month, market experts say that investors should avoid chasing sharp rally in such a short period and the surge was driven by geopolitical tensions and war related activities.

Vishal Dhawan, Founder & CEO, Plan Ahead Wealth Advisors told ETMutualFunds that investors should avoid chasing a sharp one-month rally based on momentum and the recent surge in defence-related funds was largely driven by geopolitical tensions and war-related activities.

He further added that the short-term rallies can be driven by events, but long-term returns depend on valuations, execution, and steady earnings growth; the defence sector has strong long-term potential due to higher government spending, indigenisation, and rising orders. However, long project timelines mean profits may take time to reflect, so recent sharp returns may not sustain. Chirag Muni, Executive Director, Anand Rathi Wealth Limited shared with ETMutualFunds that what we are seeing right now in defence space is a sharp momentum phase as such returns of 20 to 25% in a single month clearly indicate that sentiment and flows are driving these prices faster than fundamentals.

He further said that investors need to understand that this sector itself is cyclical and highly sensitive and its performance largely dependent on government spending cycles and geopolitical developments, in recent years, a series of geopolitical uncertainties has supported strong outperformance, but as these uncertainties stabilise, the sector may not deliver the same kind of returns going forward.

“As per historic data, such sharp rallies are usually followed by phases of consolidation or correction as sentiment cools off. Given this kind of volatility, investing in sectoral funds requires very tactical entry and exit, which may not be suitable for most regular investors. Therefore, investors should avoid entering in such sector funds or ETFs and explore diversified equity funds which invest across sectors,” Chirag said.

Valuations

Commenting on the valuations in the sector, Dhawan said that the current market optimism around defence stocks has also led to stretched valuations, the Nifty India Defence P/E is (56x) and P/B (12) are significantly higher than broader index such as the Nifty 500 P/E is (23x) and P/B (3.50). Therefore, fresh exposure may be better built gradually, especially if and when corrections result in moderate valuations over time.

Around eight defence sector based funds have completed one month of existence in the industry. Out of these eight funds, Mirae Asset BSE India Defence ETF gave the highest return of 25.16% in the last one month, followed by Groww Nifty India Defence ETF which gave 24.35% return in the same period. HDFC Defence Fund, the only actively managed fund based on the defence sector, gave a return of 22.34%, the lowest among these eight funds.

Which one to choose - passive or active defence based funds?

Chirag said in a sector like defence, the real challenge is not just stock selection but timing the cycle itself and whether you go through an ETF like Mirae Asset BSE India Defence ETF or an active fund, both are still exposed to the same sector concentration risk.

“These sectors often see sharp cycles and require timely entry and exit to capture momentum, which can be difficult for most investors to manage consistently. So chasing current momentum is not really advisable,” Chirag further said.

Dhawan said that ETFs like Mirae Asset BSE India Defence ETF can be suitable for investors who want transparent, rules-based exposure to the defence theme and investors should not assume that an ETF automatically provides broad diversification.

Actively managed defence funds may offer more flexibility in stock selection, position sizing and valuation management. However, they also carry active fund-manager risk and may still own many of the same large defence and defence-adjacent companies because the listed universe is limited. One can also wait till the track record gets formed for active funds before investing, Dhawan said.

SIP or lumpsum: How to enter defence sector?

Dhawan said that given the recent sharp rally and elevated valuations, SIPs or staggered investments may be more prudent than a large lumpsum investment and the lumpsum exposure may suit only investors with high-risk appetite, long time horizon and a clearly defined sector allocation limit.

Chirag said that a more balanced approach would be to opt for SIPs in diversified equity funds such as flexi cap, multi cap, and large and mid cap funds which also have some degree of exposure to the defence sector and these naturally spread exposure across different sectors and market caps, and are better suited for long term wealth creation with more consistent and stable outcomes

In the last one year, these funds gave an average return of 25.45%. Around six funds have completed one year of existence in the industry. HDFC Defence Fund gave the highest return in the last one year of around 27.10%, followed by Motilal Oswal Nifty India Defence ETF which gave 25.94% return. Groww Nifty India Defence ETF FOF gave the lowest return in the last one year of around 23.93%.

Should one make an exit after short term gains?

Dhawan said that investors should follow a disciplined rebalancing strategy rather than trying to predict the exact top and defence should ideally be treated as a high-risk satellite holding, not as a core equity holding.

He further said that if the rally has pushed the defence allocation meaningfully above the intended portfolio limit, partial profit-booking should be considered and the exit decision should also be linked to valuations and earnings delivery and they should track whether companies are converting order books into revenue, maintaining margins and delivering profits.

“Given the concentrated nature of defence funds and the presence of small- and mid-cap stocks, investors should also be prepared for higher volatility,” he said.

To this, Chirag said that after such a sharp run up, the focus should shift from return maximisation to risk management, when a sector delivers outsized gains in a very short period, it often leads to portfolio imbalance and higher concentration risk and the approach should not be to get carried away by short term gains, but to step back and review how much exposure the portfolio now has to this one sector.

What this essentially tells us is that investors should look at gradually booking profits rather than trying to time the absolute peak, a staggered approach works better in such situations and investors can consider moving money through an STP into diversified equity funds which will help reducing the risk of a sharp reversal impacting the portfolio, Chirag said.

According to a report by DAX Capital, over the next five years, the sector is poised to offer opportunities of nearly Rs 15 trillion, supported by sustained increases in defence capex budget and accelerating export, the escalating geopolitical tensions are expected to act as key catalysts for increased defence spending and to strengthen the sector's long term growth prospects.

The report further said that India's defence budget has grown steadily since FY20, with overall expenditure rising at 8.5% CAGR and capital spending at 10.3% CAGR. The capex allocation has doubled to Rs 2.2 trillion in FY27BE (vs Rs 1.1 trillion in FY20), with 75% directed to domestic industry, highlighting strong focus on modernization and indigenization.

Way ahead for defence sector

Commenting on the outlook, Chirag said that looking ahead, the defence sector has the potential to move higher, supported by favourable government policies and long term capital commitments. However, there is a lot of optimism around future triggers such as order wins, export growth and policy support may already be priced in as a result, a phase of mean reversion or some consolidation should not come as a surprise in the defence sector.

He further said that from an investor perspective, it is not advisable to rely on a single sector for long term wealth creation, as it increases concentration risk in the portfolio, a more sensible approach is to invest through broad based diversified equity funds such as market cap based and strategy based funds as these provide exposure across sectors, categories and market caps, helping reduce the impact of any one sector and allowing portfolios to move more smoothly across market cycles.

Dhawan said that the long-term outlook for the defence sector remains constructive as Indian defence continues to benefit from a strong structural backdrop, including higher government spending, indigenisation, domestic procurement, robust order inflows and export ambitions. "However, the investment view should remain cautious at current valuations. Defence projects often have long execution cycles, so revenue recognition and profitability may play out over several years. This can create a gap between strong order books and near-term earnings delivery. Any muted budgetary spending can also weigh on sentiment and near-term sector performance."

Overall, defence sector funds remain promising but high-risk as they are thematic, concentrated, valuation-sensitive and exposed to both geopolitical sentiment and execution risk and investors should avoid extrapolating recent one-month returns, build exposure gradually, and keep allocations within a clearly defined portfolio limit.

One should always choose a scheme based on risk appetite, investment horizon, and goals.

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