The Hindu BusinessLine

Beyond conventional investments

For well-heeled investors who want something more, alternative investments are an option. But only if they are game for risk

Falling interest rates, lacklustre returns from property, limitations in holding gold — all these are nudging investors towards shifting their asset choices. Sophisticated investors are looking at options beyond the usual picks such as debt or equity mutual funds and direct equity investments.

If the idea is to build a portfolio with a diversified set of asset classes, it pays to spread the bets across alternative investments as well. A few such instruments have been around for a while globally, and are gaining popularity in India, of late. These financial assets may, however, require higher risk taking ability and greater knowledge of the product. The minimum investment in these assets is higher, in order to exclude the more vulnerable investors.

Your portfolio, their expertise
One such choice is portfolio management services (PMS) which gives you the best of MFs (professional management) and direct equities (personalisation of portfolio).

PMS requires a minimum investment of ₹25 lakh. The money is invested in direct equity, debt or a combination based on the investment strategy of the scheme.

The service provider typically creates a few model portfolios for different investment themes and risk buckets. For instance, equity model portfolios may be built from a pool of, say, 20-25 stocks. These would have aggressive, moderate and low-risk variants.

From these, investors may select a portfolio based on their risk profile and also do any smaller customisation based on their specific needs. For example, if a certain industry must be avoided due to an investor’s other holdings, these may be accommodated. Likewise, an investor’s conflict of interest in owning certain stocks — due to the investor being a Director or having other relationships — must be considered when building a portfolio. Typically, 80 per cent of the portfolio picks remains constant while the rest may be personalised.

Good returns
Portfolio management schemes claim to offer higher absolute returns, helped by their ability to take concentrated bets and the longer holding period of investors.

For instance, ASK group’s IEP PMS portfolio has delivered compounded annual returns (CAGR) of 20.9 per cent from 2010 to February 2017. Its India Select portfolio has delivered annualised returns of 19.7 per cent in the same period. These returns are net of fees and other charges. Likewise, Motilal Oswal’s

Next Trillion Dollar Opportunity PMS scheme tops comparable MF schemes across two- three- and five-year time frames. Its five-year return is 32.6 per cent, compared with the second-ranked scheme with a return of 28.8 per cent.

Unifi Capital's Deep Value Fund has delivered 42.47 per cent annualised gains since its inception in December 2012. Sanctum's Indian Olympians PMS scheme's four-year return is 17.4 per cent vis-à-vis 11 per cent return for Nifty during the same period.

Managing risk

PMS schemes also strive to manage risks. Similar to any mutual fund, the investment process involves a committee; PMS is also regulated by SEBI and audits are performed to ensure due process is followed.

Data shows that PMS scores well on risk metrics. For instance, beta of ASK's PMS was 0.64, indicating low risk. The portfolio fell more than the market only once in the last seven years. Its Sharpe ratio was positive in five out of seven years.

Likewise, Unifi Capital's Deep Value's standard deviation since inception, of 19.5 per cent, compares well with 18.4 per cent for the benchmark (BSE Mid-cap index).

Fees and charges

There are sizeable variations in the fees charged by PMS providers to different customers. You may opt for a fixed fee structure of, say, 2-2.5 per cent. Alternatively, you may go for performance fees — for any return over a hurdle rate, you pay 20 per cent share of the excess return. The hurdle rate is a fixed percentage (not as a spread over the market) and is set based on the scheme's risk-return profile. There may also be mixed fee structure where there is a smaller fixed fee (of, say, 1 per cent) along with performance fee.

There is also transaction or brokerage fees to be paid. These are typically small — about 20bps.

Strategy

The risk-return profile and hence the suitability of a PMS product depends on the investment strategy. Typically, momentum trading, using derivatives or other short-term strategies may not offer sufficient post-tax return.

Most equity strategies tend to be long-only, and are based on the stock's fundamentals. Sanctum Wealth's Indian Olympians is built with a core portfolio of high quality companies such as Asian Paints, HDFC Bank, Hero Moto Corp, enjoying deep moats in their respective segments. The aim is to invest in potential wealth generators and reduce volatility. It has delivered four-year returns of 17.4 per cent.

ASK's PMS strategy focuses on buying high quality business with good free cash flow when they are at a discount to fair value. The fund has invested in stocks of Motherson Sumi, Lupin and Indusind Bank.

The aim of these funds is to get long-term predictive earnings growth in the stock investments. Portfolio churn is usually kept low. A case in point is Ambit, whose equity PMS portfolio (focussed on small- and mid-cap stocks) had a churn of 12 per cent last year.

Unifi Capital's Deep Value @ Discount Fund identifies and invests in deep value buys. These may arise out of situations such as sector down-cycle, valuation mismatch that arises from de-mergers of disparate divisions into companies and compulsions of large institutional investors causing value buying opportunities. For instance the fund invested in a chemical company because the promoters were regularly increasing their stakes in the company. It had a single digit P/E and large surplus capacities. After the fund invested in the company, it witnessed a strong growth in earnings and its PE multiple improved significantly, generating superior capital appreciation.

Debt PMS may bet on high-yield bonds with their strength in performing credit appraisal and diligence. NCDs, collateralised corporate debt for good brands, are also other popular strategies.

There are also multi-asset portfolios — gold, bond and equity — which aim at maintaining risk in line with bond portfolio, yet earn higher return. For example, Ambit's multi asset PMS hopes to deliver 2 per cent higher return vis-a-vis bond portfolio.

An investor may use PMS as a satellite strategy for a diversified core mutual fund portfolio. For example, if the investor targets portfolio return of 12 per cent, based on the risk profile, let us assume that 40 per cent of it is allocated to equities. A portion of this — say, up to 50 per cent — may be invested in PMS to boost returns and meet the overall return expectation.

Selecting a PMS

When selecting a PMS, you must look at the track record of the provider and the manager. It helps to understand the process in place to ensure strategy continuity if there is a change in management.

The uniqueness of the strategy vis-à-vis existing mutual fund schemes also matters. You must understand the selection criteria to pick stocks in the portfolio and the considerations to sell.

You must focus on net return, after fees and taxes rather than gross portfolio return — as high churn strategies may not be tax efficient. Keep an eye on risk-adjusted performance, so that providers do not take on high risks, hoping to boost returns.

The fee structure may also be worth negotiating. Many schemes do not charge any fee if the hurdle rate is not cleared. But the flip side may be that the fund may take undue risk. Based on the provider, you must pick the structure that aligns with your interest.

Some PMS providers may also let you pick the stocks and trade. These are called non-discretionary portfolios. This may also be an option to consider if you want to participate in the process while making the final decision yourself.

Other factors

Given the many bells and whistles, there may be other considerations too. For instance, while the minimum threshold for PMS investment is ₹25 lakh, some providers may only entertain those with a portfolio value of at least ₹1 crore.

If your time horizon is less than three years, an equity PMS may not be suitable for you. Ideally, like any equity investment, it works well if the investment period is at least five years. Some providers such as ASK even charge an exit load for withdrawals made before 3 or 3.5 years. Unifi's Deep Value Fund has an expected time frame of 36 months, but your capital would be returned earlier if the portfolio doubles.

Performance comparison is not easy in a PMS. Your returns may differ from that of the model portfolio; it may also not be possible to compare returns among different clients for the same strategy.

As an investor, you may find that a PMS involves more work compared to a mutual fund. For example, the trades that happened in the demat account of the PMS must be included in your tax return. The PMS provider provides the statements but the investor has more work and responsibilities.

(This article was published on March 11, 2017)