Mutual Funds can drive economic efficiency in the next decade

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As equities mutual funds go, better allocation of resources to productive and profitable ventures boosts the productivity of the Indian economy many-fold.

In more ways than one, the mutual fund industry has been on solid ground than it has ever been before. The Indian economy has been expanding driving growth in assets under management of mutual funds. Yes, there have been more than a few dips over the last decade as the industry has been evolving, regulations have been changing, markets have been going through cycles, but by and large, mutual funds have come a long way this past decade.

The past decade

Ten years ago, given the lower penetration and lack of understanding of equities and its wealth creation potential in the long run, it was difficult to imagine a nearly nine-fold increase in equity assets under management (AUM). But from an AUM of Rs 40757 crore in June 2005 equity assets have marched ahead to the current Rs 3.6 lakh crore, a 24.5 percent CAGR growth. Extrapolating this growth, the AUM of equity funds could reach up to Rs 32.5 lakh crore in the next decade, which is a huge sum.

The past few years were not without its challenges for equity assets, especially when there were cyclical shifts in the economy. Equity AUMs fluctuated wildly and saw some sharp declines in the year 2009 when markets declined drastically, post the Lehman-crisis. However, the subsequent recovery in the markets, and investor appetite at lower levels saw equity AUMs rebound equally well in 2010 rising back to levels of nearly Rs 2 lakh crore.

Over the last decade, fund management practices, too, have improved a lot with the implementation of process-driving investment selection. Disclosures have also improved dramatically.

The past two years, however, have been watershed for the growth of equity funds. Assets under management have nearly doubled to Rs 3.6 lakh crore driven by strong investor appetite and a steady performance by equity mutual funds overall.

Now equity assets seem to be set on course for many years of growth, as investors are now more willing to understand the potential of equities to provide inflation-beating returns. The fund industry has been working hard to ensure that plenty of information is distributed about the idea of equity as an investment class, its potential, and its performance.

The decadal performance is outstanding

There's no doubt that the Indian economy has been delivering despite clocking slower growth rates in the last decade. Stock markets have been mirroring the growth. The BSE Sensex returned a solid 14.5 percent CAGR over the last decade. But the one aspect of mutual funds that stands out is its benchmark-beating performance. Not only that, most equity funds have delivered about 2-3 percentage points higher than the frontline indices clearly demonstrating that a careful built portfolio does well over longer periods of time.

Over the next decade, given that the Indian economy is at an inflection point and with the multiple reforms that have been launched by the government, the stock markets are likely to provide a better investor experience in equity assets. Hence, equity mutual funds have a decent chance of showing good returns to investors.

Size drives new investing strategies

Inflows into equity and debt funds have been rising, giving rise to far more diversity in fund management styles from value to growth, as well as a mix of both. Once the industry becomes bigger, new investment strategies will have to be devised that goes may often go against the herd, like contrarion thinking that seeks-out-of favour and value-based investing ideas.

However, a large-sized mutual fund need not be a hindrance. If you look at some of the Indian companies over the last decade, some have grown their market capitalisations by leaps and bounds. Likewise, mutual funds too can manage their size well for which deep thinking and analysis both on the contrarion and value-investing side will be required.

Funds set to improve economic efficiency

What's more, a cataclysmic shift seems to be taking place towards financial assets. Household savings towards equities and debentures is barely around 1.3 percent of GDP (RBI annual report 2014). However, that is likely to rise in the coming decade.

Investors were hit by inflation in the last many years and hence sought physical assets like gold and real estate to beat inflation. But with inflation trending lower and below target levels, investor will increasingly seek out financial assets such as equities and debt.

Unlike money going to gold, which does not yield dividend or returns, money entering the equity markets would be beneficial to the economy. It would lead to increased productivity in the economy than if it went into gold or real estate. Fund managers allocate equity resources to the most productive and efficient companies.

Fund management also helps to channelize resources to the sectors of the economy where capital is most needed, and where the best profit growth is. Hence, it drives all-round improvement and significantly strengthens the Indian economy, and competitiveness.

Market cycles can sully investor experience

But what the past decade has taught us is that market cycles can play spoilsport with returns in the short run. As cycles shift either from one asset class to another, or when money flows out from an asset class, the transition can leave investors straddled and faced with a loss of money.

Attractiveness of returns has never been a problem for mutual funds. Over the past decade and two, investors have seen strong returns from mutual funds, but investor experience across cycles is sometimes an issue. One such period has been during 2007 when inflows into infrastructure peaked as stock valuations hit the roof.

Hence, over the next decade strategies that are driven by quantitative models and which factors into account whether prices of asset classes are under- or over-priced will become more popular. Balanced and hybrid funds could also become bigger as investors walk down a conservative path to ride out the volatility in asset classes.

All in all, the future of the fund industry looks bright as the shift towards financial assets is underway. In addition, funds that offer unique value propositions and investing strategies will be sought after by investors, which will drive the industry forward. But there’s really no doubt that better days await the mutual fund industry, and its investors.