Given a choice, we would prefer to have the best in everything – buy the best car, get the best job, eat the best food, watch the best content… you get the drift!

This is perfectly obvious. After all, why should we go for things that do not meet the best standards especially when we can afford the best.

Most of us tend to apply the same 'best' filter to choose our equity funds. We google for funds that have given exceptional returns in the past and invest in them.

On paper, choosing funds based on past performance sounds quite logical.

But, has this strategy worked in the past?

Let us take the top quartile performers (funds in the top 25% on the basis of returns) for the 3-year period from Jan-16 to Dec-18.

Can you guess what percentage of them held on to the top spot in the next 3-year period (Jan-19 to Dec-21)?

a) 60 to 100%

b) 30 to 60%

c) 0 to 30%

If we think about it, at least 60% of the funds should have managed to retain the top position. All said and done, why would more than 40% of the top performers be underperforming.

Going by this, it should be Option A.

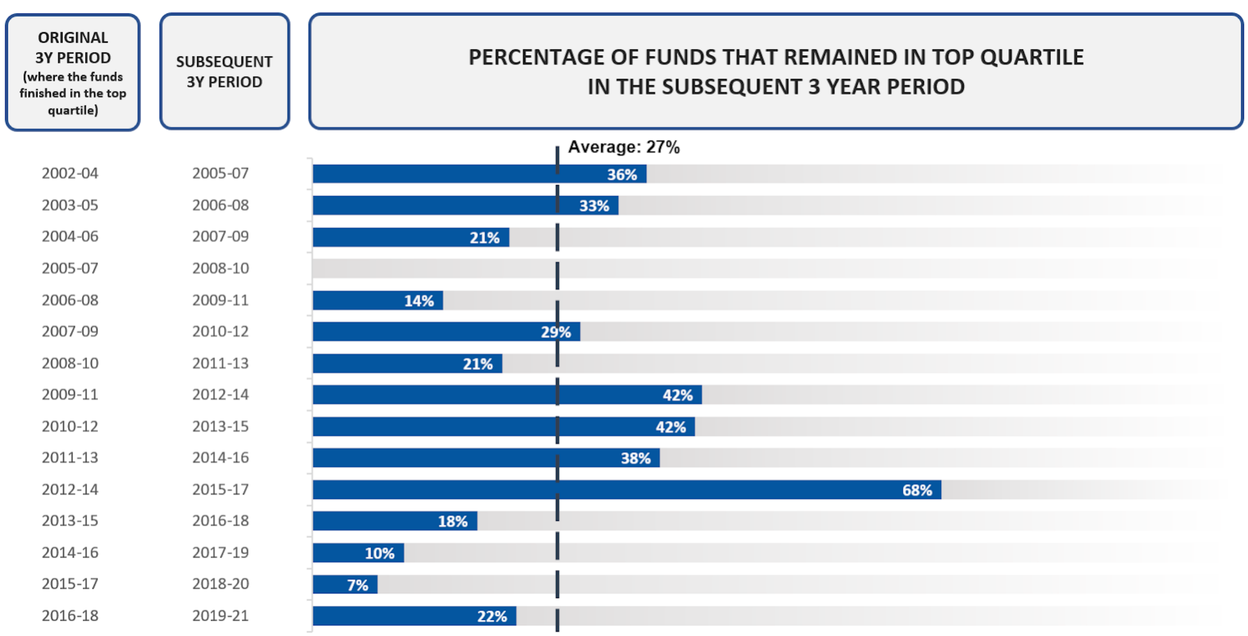
But here comes the shocker – The correct answer is not Option A and it is not even B.

The answer is C!

Just 22% of the 2016-18 top quartile performers remained in the top spot during 2019-21.

What if this was just a one-off?

Let's look at what happened for different 3-year periods in the past 20 years.



Source: FundsIndia Research, MFI; Note: The quartile ranking is based on returns of diversified equity mutual funds (Large Cap, Mid Cap, Small Cap, Flexicap, Large & Midcap, Multicap, ELSS, Value/Contra, Focused & Dividend Yield) for 3 year periods starting Jan-02 to Dec-04 and returns for the subsequent 3 year periods.

The percentage of the top quartile performers that continued to be in the top quartile in the subsequent 3 years has varied significantly.

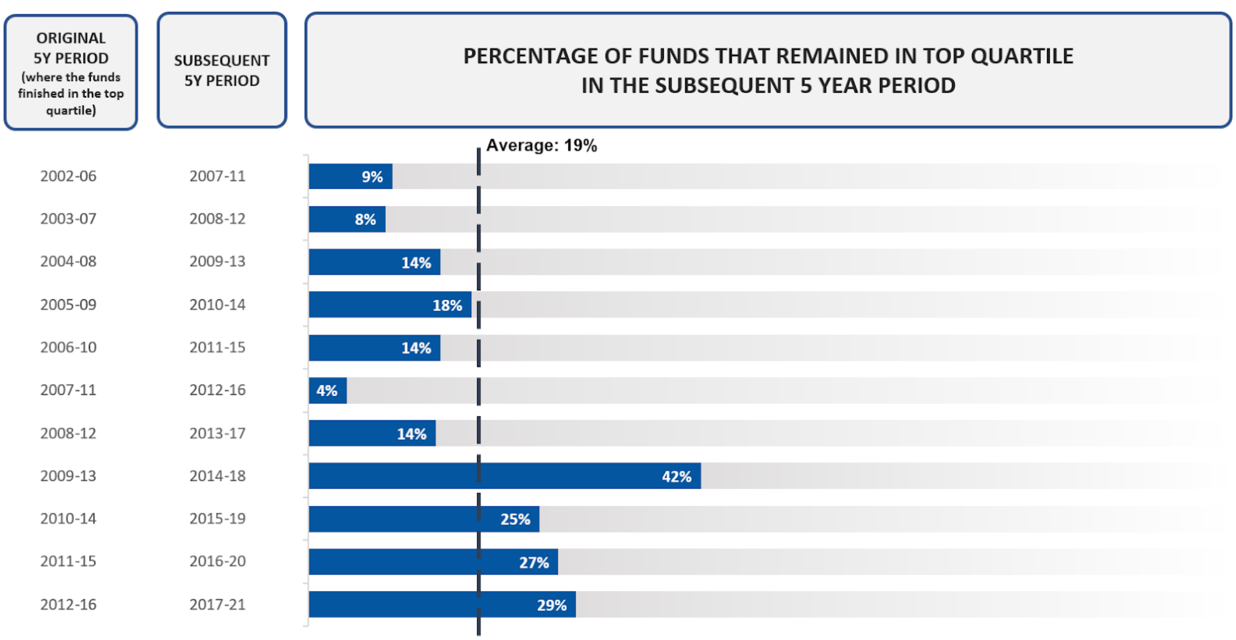
In the past two decades, the odds of making a successful investment purely based on past performance swung between 0% (none of the 2005-07 top quartile performers made it to the top in the next 3 years!) and 68%.

On average, only 27% of the funds that finished in the top quartile continued to be top performers in the subsequent 3-year periods.

This means that your clients just had a 27% chance of investing in a top-performing fund by basing their decision on past performance.

Not convinced yet?

The consistency drops even further when seen from a 5-year perspective.



Source: FundsIndia Research, MFI; Note: The quartile ranking is based on returns of diversified equity mutual funds (Large Cap, Mid Cap, Small Cap, Flexicap, Large & Midcap, Multicap, ELSS, Value/Contra, Focused & Dividend Yield) for 5 year periods starting Jan-02 to Dec-06 and returns for the subsequent 5 year periods.

The odds of picking a successful fund were a mere 19%.

Some more evidence…

To add more context, we can now take a look at the same thing at a fund level.

Let us take the top 30 funds (ranked on the basis of returns) for different 3-year periods and find out where those funds ranked in the next 3 years.

How did the 30 Top Funds Fare in the Subsequent 3Y Period?

2009-11	2012-14	2010-12	2013-15	2011-13	2014-16	2012-14	2015-17	2013-15	2016-18	2014-16	2017-19	2015-17	2018-20	2016-18	2019-21
1	38	1	103	1	1	1	7	1	2	1	6	1	175	1	22
2	15	2	15	2	40	2	48	2	34	2	30	2	20	2	17
3	31	3	33	3	27	3	8	3	166	3	168	3	161	3	63
4	27	4	13	4	31	4	2	4	140	4	95	4	68	4	184
5	17	5	57	5	53	5	33	5	116	5	148	5	139	5	84
6	14	6	11	6	11	6	12	6	106	6	116	6	177	6	163
7	1	7	2	7	12	7	44	7	134	7	160	7	64	7	98
8	16	8	12	8	26	8	114	8	14	8	130	8	95	8	97
9	120	9	19	9	90	9	6	9	85	9	68	9	171	9	109
10	51	10	62	10	55	10	74	10	75	10	154	10	156	10	102
11	25	11	21	11	92	11	73	11	156	11	147	11	92	11	2
12	101	12	6	12	14	12	30	12	46	12	166	12	122	12	39
13	29	13	27	13	104	13	13	13	43	13	167	13	154	13	105
14	36	14	128	14	24	14	46	14	60	14	129	14	9	14	156
15	104	15	93	15	2	15	126	15	125	15	144	15	173	15	85
16	24	16	30	16	144	16	20	16	96	16	109	16	90	16	106
17	116	17	43	17	10	17	51	17	131	17	137	17	93	17	59
18	67	18	91	18	81	18	3	18	12	18	98	18	116	18	144
19	74	19	55	19	96	19	37	19	57	19	120	19	71	19	49
20	105	20	14	20	141	20	28	20	105	20	113	20	147	20	119
21	3	21	132	21	137	21	11	21	145	21	163	21	100	21	57
22	12	22	121	22	136	22	85	22	91	22	104	22	129	22	171
23	131	23	70	23	47	23	10	23	101	23	88	23	172	23	117
24	113	24	45	24	52	24	9	24	49	24	157	24	142	24	182
25	2	25	24	25	147	25	19	25	55	25	85	25	85	25	38
26	139	26	38	26	25	26	16	26	129	26	66	26	32	26	15
27	35	27	47	27	95	27	141	27	44	27	133	27	135	27	23
28	64	28	44	28	80	28	25	28	26	28	164	28	102	28	77
29	102	29	40	29	43	29	23	29	79	29	87	29	127	29	169
30	100	30	146	30	113	30	31	30	158	30	67	30	134	30	46
Total Number of Funds in the Universe															
125	145	135	148	141	152	145	158	148	167	152	168	158	177	167	186

Ranked below 30

Source: MFI, FundsIndia Research. The table shows the ranking of diversified equity funds (Largecap, Midcap, Smallcap, Flexicap, Large & Midcap, Multicap, ELSS, Value/Contra, Focused & Dividend Yield) based on 3 Year returns. The first column in each section shows the rank based on 3Y Returns during the specified period. The second column shows the ranking of the same fund in the subsequent 3Y Period.

The top performers during any given period have largely dropped down the pecking order in the subsequent periods.

All the above evidence makes it very clear that investing in equity funds **ONLY** based on past performance rarely works.

Why does this happen?

Like most things in life, equity funds go through their cycles i.e. they go through a good period followed by a bad period, and then they go through the cycle again.

These cycles can be viewed under 4 lenses –

1. Cycles in different Investment Styles (Quality, Growth, Value etc)

2. Cycles in Small Cap vs Mid Cap vs Large Cap
3. Cycles in different Sectors
4. Cycles in Equity Markets of Different Countries

Different investments styles do well at different times

History and global evidence show us that a group of stocks with specific characteristics and styles such as Quality, Value, Size (Mid/Small Cap), Momentum, Low Volatility and Dividend Yield have delivered superior returns over the long run.

However, not all investment styles work well at a given time. Each style exhibits phases of strong returns followed by phases of poor returns and vice versa. This goes on and the styles keep moving in and out of favour (as can be seen from the below table).

Over the long run, most styles do well as their outperformance during good phases compensates for their weak performance in bad phases.

Style Returns by Calendar Year

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Dividend Yield 34%	Global 21%	Size (Midcap) 47%	Global 50%	Value 79%	Momentum 11%	Value 25%	Momentum 57%	Quality 9%	Global 34%	Quality 26%	Value 56%
Value 31%	Quality -10%	Momentum 39%	Quality 20%	Size (Midcap) 63%	Low Volatility 10%	Global 15%	Size (Midcap) 56%	Low Volatility 7%	Nifty 50 TRI 13%	Size (Midcap) 26%	Momentum 54%
Quality 28%	Low Volatility -12%	Dividend Yield 34%	Momentum 13%	Momentum 50%	Size (Midcap) 10%	Dividend Yield 13%	Value 47%	Nifty 50 TRI 5%	Momentum 11%	Low Volatility 24%	Size (Midcap) 48%
Low Volatility 25%	Dividend Yield -13%	Value 32%	Nifty 50 TRI 8%	Quality 40%	Global 6%	Momentum 10%	Low Volatility 30%	Global 4%	Quality 6%	Global 21%	Dividend Yield 34%
Size (Midcap) 20%	Momentum -16%	Low Volatility 32%	Low Volatility 7%	Low Volatility 37%	Quality 2%	Size (Midcap) 7%	Nifty 50 TRI 30%	Dividend Yield 1%	Low Volatility 5%	Momentum 20%	Global 31%
Momentum 20%	Nifty 50 TRI -24%	Quality 31%	Size (Midcap) -1%	Dividend Yield 37%	Nifty 50 TRI -3%	Nifty 50 TRI 4%	Quality 30%	Momentum -2%	Dividend Yield 1%	Nifty 50 TRI 16%	Quality 26%
Nifty 50 TRI 19%	Size (Midcap) -31%	Nifty 50 TRI 29%	Dividend Yield -5%	Nifty 50 TRI 33%	Value -7%	Low Volatility 3%	Dividend Yield 29%	Size (Midcap) -13%	Size (Midcap) 1%	Dividend Yield 16%	Nifty 50 TRI 26%
Global 10%	Value -38%	Global 19%	Value -14%	Global 16%	Dividend Yield -9%	Quality 1%	Global 15%	Value -26%	Value -14%	Value 8%	Low Volatility 24%

Source: FundsIndia Research, MFI; The indices considered are as follows: Quality - Nifty 200 Quality 30 Index TRI, Value - Nifty 500 Value 50 TRI, Size (Midcap) - Nifty Midcap 150 TRI, Global - S&P 500 TR INR, Momentum - Nifty 200 Momentum 30 Index TRI, Low Volatility - Nifty 100 Low Volatility 30 TRI, Dividend Yield - Nifty Dividend Opportunities 50 TRI

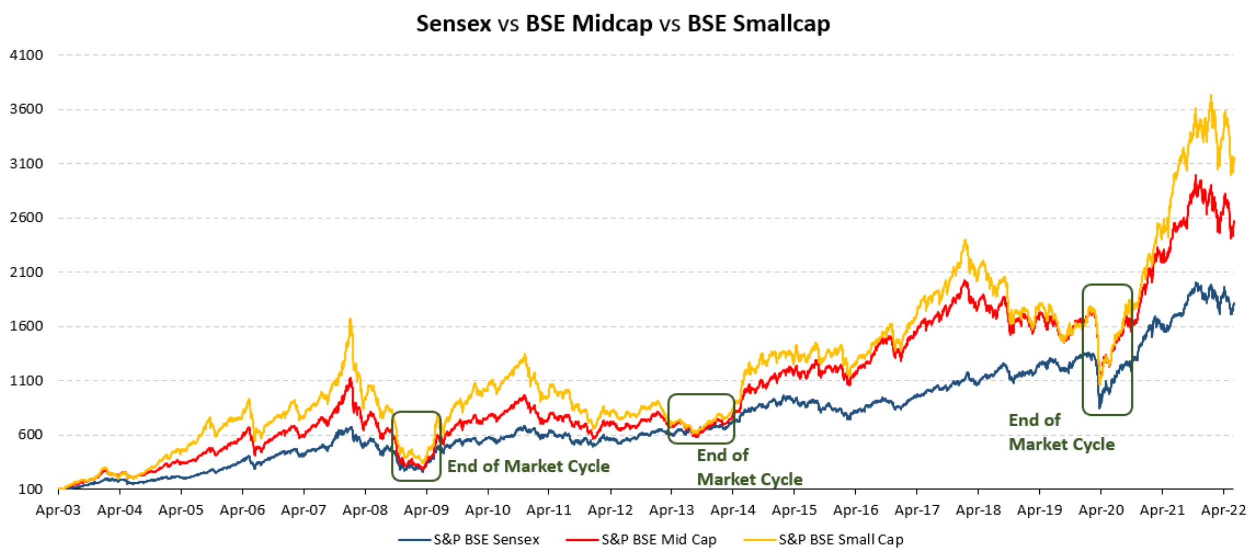
Different market cap segments do well at different times

Like styles, the performance of different market cap segments i.e. large-cap, mid-cap and small-cap vary with time. The market sometimes favours larger companies and sometimes smaller ones.

Market Cap Segment Returns by Calendar Year

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Mid Cap 20%	Large Cap -25%	Mid Cap 47%	Large Cap 8%	Small Cap 72%	Small Cap 11%	Mid Cap 7%	Small Cap 58%	Large Cap 3%	Large Cap 12%	Small Cap 26%	Small Cap 63%
Large Cap 19%	Mid Cap -31%	Small Cap 40%	Mid Cap -1%	Mid Cap 63%	Mid Cap 10%	Large Cap 5%	Mid Cap 56%	Mid Cap -13%	Mid Cap 1%	Mid Cap 26%	Mid Cap 48%
Small Cap 18%	Small Cap -35%	Large Cap 33%	Small Cap -6%	Large Cap 35%	Large Cap -1%	Small Cap 1%	Large Cap 33%	Small Cap -26%	Small Cap -7%	Large Cap 16%	Large Cap 26%

Source: FundsIndia Research, MFI; The indices considered are as follows: Large Cap - Nifty 100 TRI, Mid Cap - Nifty Midcap 150 TRI, Small Cap - Nifty Small Cap 250 TRI



Source: MFI, FundsIndia Research. As on 31-May-22. Asssuming a base value of 100 on 01-Apr-03

Different sectors do well at different times

Even the best-performing sectors keep rotating. Most sectors that have featured at the top in a particular year have also ended up at the bottom during other years.

Sector Returns by Calendar Year

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Realty 464%	Utilities 153%	FMCG -20%	Metals 227%	Healthcare 36%	FMCG 9%	Media 59%	IT 58%	Financials 57%	Healthcare 12%	Metals 45%	Realty 106%	IT 24%	Realty 27%	Healthcare 57%	Metals 70%
Metals 94%	Metals 139%	Healthcare -30%	Auto 194%	Auto 35%	Healthcare -13%	Realty 53%	Healthcare 21%	Auto 57%	Media 10%	Oil & Gas 27%	Cons Disc. 54%	FMCG 14%	Financials 26%	IT 55%	Utilities 64%
Media 74%	Oil & Gas 115%	Telecom -49%	IT 166%	FMCG 31%	Telecom -16%	Financials 52%	Telecom 18%	Cons Disc. 54%	Cons Disc. 8%	Auto 11%	Telecom 49%	Financials 11%	Telecom 13%	Cons Disc. 20%	IT 60%
Telecom 56%	Financials 83%	Oil & Gas -55%	Cons Disc. 107%	Financials 30%	IT -18%	FMCG 49%	FMCG 12%	Healthcare 46%	Telecom 3%	Utilities 10%	Metals 49%	Healthcare -6%	IT 8%	Metals 16%	Realty 55%
Oil & Gas 40%	Telecom 82%	IT -55%	Financials 89%	IT 29%	Auto -19%	Auto 42%	Auto 9%	Media 33%	FMCG 0%	Financials 5%	Financials 41%	Utilities -15%	Oil & Gas 7%	Telecom 14%	Telecom 43%
Financials 40%	Realty 71%	Auto -55%	Media 82%	Cons Disc. 12%	Cons Disc. -23%	Cons Disc. 40%	Oil & Gas 4%	Utilities 20%	IT 0%	Cons Disc. 5%	Oil & Gas 34%	Oil & Gas -16%	FMCG -1%	FMCG 13%	Media 35%
IT 39%	Media 61%	Financials -55%	Oil & Gas 73%	Media 4%	Oil & Gas -29%	Healthcare 33%	Media 1%	FMCG 18%	Auto 0%	FMCG 3%	Media 33%	Cons Disc. -16%	Cons Disc. -2%	Auto 11%	Cons Disc. 30%
Cons Disc. 37%	Cons Disc. 39%	Utilities -56%	Utilities 71%	Telecom 2%	Financials -29%	Metals 18%	Cons Disc. -3%	IT 18%	Oil & Gas -3%	Media -1%	Auto 31%	Metals -20%	Healthcare -7%	Realty 9%	Oil & Gas 24%
Auto 28%	FMCG 22%	Cons Disc. -66%	Realty 70%	Oil & Gas 1%	Media -33%	Oil & Gas 13%	Financials -7%	Oil & Gas 12%	Utilities -4%	Realty -6%	Utilities 30%	Auto -23%	Utilities -7%	Financials 4%	Auto 19%
Healthcare 23%	Healthcare 17%	Media -69%	Healthcare 69%	Metals 0%	Utilities -34%	Utilities 10%	Utilities -14%	Telecom 9%	Financials -5%	IT -7%	FMCG 29%	Media -26%	Auto -11%	Utilities 0%	Healthcare 18%
Utilities 20%	Auto 5%	Metals -74%	FMCG 42%	Utilities -6%	Metals -48%	IT -2%	Metals -14%	Realty 8%	Realty -14%	Healthcare -14%	IT 12%	Realty -31%	Metals -11%	Oil & Gas -4%	Financials 14%
FMCG 17%	IT -11%	Realty -82%	Telecom -7%	Realty -26%	Realty -52%	Telecom -3%	Realty -32%	Metals 7%	Metals -31%	Telecom -21%	Healthcare -3%	Telecom -41%	Media -30%	Media -9%	FMCG 10%

Source: FundsIndia Research, MFI; The indices considered to represent each sector are as follows: Auto: Nifty Auto; Cons Disc.: S&P BSE Consumer Disc Goods & Services; Financials: Nifty Financial Services; FMCG: Nifty FMCG; Healthcare: Nifty Healthcare Index; IT: Nifty IT; Media: Nifty Media; Metal: Nifty Metal; Oil & Gas: S&P BSE Oil & Gas; Realty: S&P BSE Realty; Telecom: S&P BSE Telecom; Utilities: S&P BSE Utilities

Different geographies do well at different times

Likewise, there is no single best investment country that consistently offers the highest returns. Different equity markets have done well at different points.

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
USA 21%	India 32%	USA 50%	India 28%	USA 6%	USA 14%	China 45%	USA 4%	USA 34%	China 33%	USA 29%
World 13%	China 27%	World 44%	USA 16%	World 4%	World 11%	Asia 34%	World 0%	World 31%	Asia 28%	India 27%
Europe 6%	Asia 26%	Europe 42%	China 11%	Europe 2%	Asia 8%	India 30%	India 0%	Europe 27%	USA 24%	World 24%
Asia -1%	Europe 23%	China 17%	World 8%	India 0%	China 4%	Europe 19%	Asia -6%	China 26%	World 19%	Europe 19%
China -3%	World 20%	Asia 17%	Asia 8%	China -3%	Europe 3%	World 16%	Europe -6%	Asia 21%	India 11%	Asia -3%
India -20%	USA 19%	India 15%	Europe -4%	Asia -5%	India -1%	USA 15%	China -11%	India 8%	Europe 9%	China -20%

Source: Bloomberg, Mirae Asset MF. Based on MSCI country Indices. Asia excludes Japan. Returns in INR terms.

When your clients invest ONLY based on recent performance, their portfolio is likely to be biased towards specific styles, market cap segments, sectors and geographies. And when the cycle turns, their entire portfolio could go through prolonged underperformance.

So, how should your clients invest?

1. Do not choose Equity funds ONLY based on past performance

While past performance is a useful metric to evaluate a fund, it can never be the only one. Ideally, your clients should look at a number of quantitative and qualitative factors to derive conviction on the future potential of a fund.

Quantitatively, your clients can look for the following in a fund

- Consistency in Outperformance on a Rolling Basis versus Benchmark over 1-2 market cycles
- Consistency in Performance on a Rolling Basis versus Peers over 1-2 market cycles
- Ability to contain Downside during Market Declines over 1-2 market cycles
- Preferably Low Churn
- No Over-Concentration in the Portfolio
- Reasonable Size
- Reasonable Liquidity Among Portfolio Constituents

Qualitatively, your clients can look for the following in a fund

- Robust Investment Process (and the ability to stick to the style even when it is not in favour)
- Track Record of the Fund Management Team
- Clear Communication of Strategy and Process (especially during periods of underperformance)
- Pedigree of the AMC

2. Diversify! Diversify!! Diversify!!!

Diversify your client's equity funds across investment styles, market caps, sectors and geographies.

Internally, we use a portfolio construction strategy called the 5 Finger Framework where the investments are made equally into funds that follow five different investment styles – Quality, Value, Blend, Mid/Small and Global. You can read our detailed blog to know more about this.

Summing it up

Choosing funds with the highest recent returns intuitively seems like a logical approach.

However, historical evidence makes it clear that the odds of picking a future top performer only based on past performance are staggeringly low.

A better approach to build your client's equity fund portfolio would be choosing funds using quantitative and qualitative parameters and diversifying their investments across different styles, market caps, sectors and geographies.