Don't Allow Greed and Fear to Impact Your Stock Picks

Expert Take

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Most of us make the same mistake with our money over and over again. We buy high out of greed and sell low out of fear, despite knowing on an intellectual level that it is a very bad idea.

To support this, we analysed data for inflows and outflows in mutual funds equity schemes (cumulative of equity funds, ELSS and balance funds). The period under evaluation was January 1, 2007 to December 2010 because during this period we saw the peak of the market followed by the bottom of the market and again the scaling back to the previous peak.

It was observed that consistent inflows have came in 2007 and the first half of 2008 when the market was scaling new highs. A total of ₹47,991crore of net inflows were registered from January 2007 to September 2008. From October 2008 to April 2009, the inflows were drying out. Interestingly, when the market was trading at dirt cheap valuations from October 2008 to March 2009, there were net outflows of ₹1,772 crore, indicating investors were booking losses due to sheer fear. From May 2009 onwards as the market was again crawling back due to improved sentiments and easy global liquidity, continuous redemptions were taking place from equity funds. Total redemption of ₹15,866 crore took place from August 2009 to December 2010.

Greed made people invest heavily in equities in 2007 and 2008. We have seen conservative investors allocating major portion in equities. Fear restricted them to invest more when the market was trading at the best possible bargain i.e. between September 2008 and March 2009. On the contrary, there was net redemption to the tune of ₹1,772 crore. We have observed that aggressive investors turned bearish and started redeeming their equity investments.

Fear made them pull out money invested at higher valuations of the market at different points when the market was scaling back. This has resulted in booking hefty losses: A majority of us don't do the asset allocation in the first place and those who had done the asset allocation did not stick to it. We further evaluated the result of investments made at higher valuations. During the selected period i.e. from January 1, 2007 to December 31, 2010, the Sensex corrected by over 60% and scaled back to the same peak in November 2010. During this correction, we saw substantial redemption out of fear.

Returns of Top 10 Diversified Funds Vs BSE Sensex*

SCHEME	ABSOLUTE RETURN
IDFC Premier Equity Fund - Plan A - Growth	161.31
ING Dividend Yield Fund - Growth	118.23
UTI Dividend Yield Fund - Growth	117.39
Birla Sun Life Dividend Yield Plus - Growth	113.39
Reliance RSF - Equity - Growth	110.48
UTI Opportunities Fund - Growth	104.56
HDFC Top 200 - Growth	103.56
Tata Dividend Yield Fund - Growth	103.00
HDFC Equity Fund - Growth	102.67
Tata Equity P/E Fund - Growth	101.61
BSE Sensex	45.30

*From Jan 1, 2007 to Dec 31, 2010

During the same period, we evaluated the returns delivered by the top 10 diversified equity funds. It can be clearly observed (see table above) that if the investments had stayed on, the returns on investments would have been far superior. The top 10 diversified funds delivered returns in the range of 101-161% as compared to 45% from the BSE Sensex.

We strongly advise investors to follow asset allocation. Do periodic review of asset allocation and take corrective action. Some prudent way of managing investments are as follows: Start with deciding strategic asset allocation based on risk profile, capability checking, cash-flow analysis and goal planning. Prepare a comprehensive investment plan to cover all the needs. Select the right product to construct the portfolio. At this level, always check the risk profile of the product. Don't just go by returns. Always check the consistency of performance, the track record of the und manager, risk-adjusted returns etc. Implement the investment plan. Keep in mind the market conditions and product suitability to attain the stated strategic allocation.

Rebalancing of portfolio is an extremely important exercise. Rebalancing should be done once a year or when strategic asset allocation changes due to market movement.