Date : 20-Jul-2010 Edition : Bangalore Page No.: 3 Page Name: My Money Size: 344.69 sq. cm

Sector: Banking and Finance Circulation: 23000 AVE: INR 524198.49 Frequency: Daily

News monitored for: Kotak Mutual Fund

LIVE RICH FINANCIAL Chronicle

Poor MF returns? Check out on the fund manager

Using publicly available data, you can rate the efficiency of a fund

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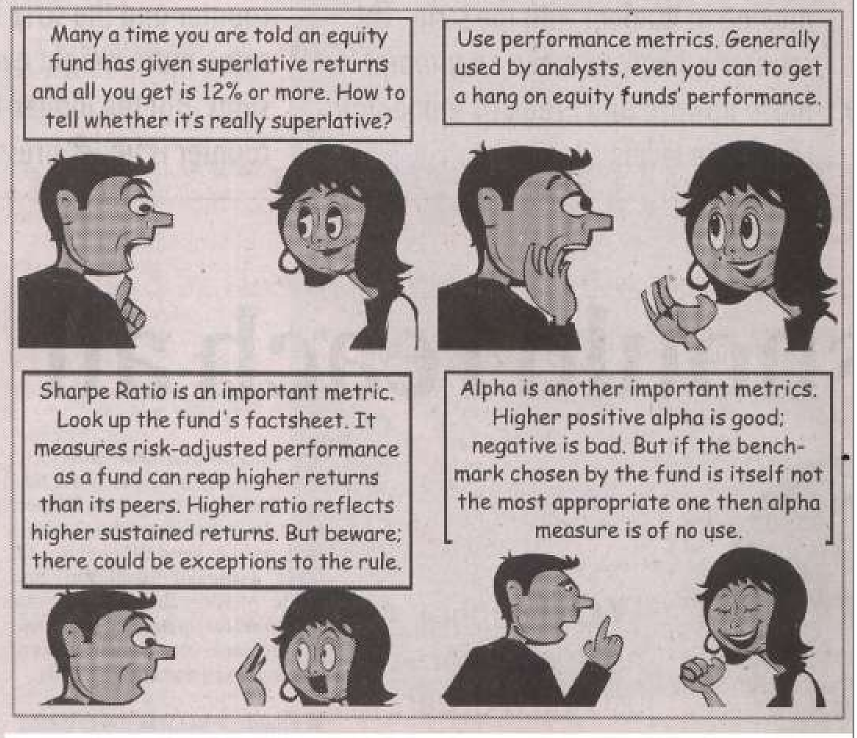

IF you have remained undecided about your fund manager after looking at the 18 per cent return notched up by your equity fund in the past two years, help is here.

There is a set of metrics that professional analysts use to assess a fund manager. *Financial Chronicle* shows you how non-professionals can use these to determine the value delivered by a fund manager. One can find some of these data in monthly fact sheets published by asset management companies and also various mutual fund websites.

Let's begin with Sharpe ratio, which measures whether the returns notched up by a mutual fund portfolio are due to smart decisions or excessive risk. Sharpe ratio measures risk-adjusted performance as a fund can reap higher returns than its peers by taking too much additional risk.

Mathematically, the ratio is derived by subtracting the risk-free rate from the rate of return of a portfolio and dividing the result by the standard deviation of portfolio returns.

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The greater this ratio, the better its risk-adjusted performance has been. For example, Birla Sun Life Dividend Yield Plus, which has given 18.49 per cent returns in three years, has a Sharpe ratio of 0.56. In comparison, ING Dividend Yield's three-year return of 18.37 per cent has come with a Sharpe ratio of 0.52, according to Value Research data, which uses SBI fixed deposit rate for 46-90 days as risk-free rate.

But just don't base your decision on this ratio alone as the table shows both UTI Dividend Yield and IDFC Premier Equity (Plan A) have same ratio, but their returns vary 300 basis points.

A fund consists of stocks, which may also move up due to the overall market movement. Alpha helps find out what portion of a fund's return can attribute to the fund manager's skill rather than market movement.

A positive alpha implies that a fund manager has added value over and above the market performance. On the other hand, a negative alpha could indicate that the manager has reduced value of the fund by underperforming the market. The conventional way of calculating alpha — which is the most basic measure of a fund manager's contribution to investment yield — is to deduct the benchmark's percentage return from the fund return.

Note that alpha can be either inflated (when the market is up) or deflated (when the market is down) by the percentage change in the benchmark itself. "To benefit from alpha, it should be taken for three years;" said Hiren Dhakan, an associate fund manager with Bonanza Portfolio.

Morningstar data shows although three-year annualised returns of growth schemes of Reliance Tax Saver Fund (8.63 per cent) and HDFC Long Term Advantage Fund (8.08 per cent) do not differ much, the former has a three-year Alpha of 1.18 while the latter has a three-year alpha of (-) 0.11.

Of course, the alpha measure is only as good as the beta used to compute it. Beta measures volatility of a portfolio in comparison with the broader market. A beta of 1 indicates that the portfolio value will move with the market. A beta of less than 1 could mean that the portfolio will be less volatile than the market. Many portfolios with utilities could have a beta of less than 1. However, a technology-oriented portfolio will have a beta of greater than 1, offering the possibility of higher rate of return with more risk.

Another indicator is R-Squared, which measures how closely your fund manager's returns match the returns of the benchmark against which it is compared.

"Like others, the tool is not for selecting a fund, but for evaluation of performance," said Anil Rego, CEO of Right Horizons. So, if a mid-cap fund has an R-Squared of 40 per cent, it indicates very little correlation with the chosen benchmark. While straying from your benchmark is not bad, it should be matched with risk-adjusted returns.

Lastly, standard deviation measures how much the return on the fund is deviating from the expected normal returns. As an investor you should be worried if the return of your pharma fund is very high or very low from expected returns (based on historical data). "Peer comparison is a must. For instance, two mutual funds where one gained and the other lost 1 per cent each and every month over the past 36 months will both have a standard deviation of zero, because its monthly returns didn't change from one month to the next," said Sanjay Das, a Kolkata-based financial adviser.

When ratios don't work

Top ten equity diversified funds show equally strong sharpe ratios but varying returns

Scheme name	Return 3 yr (%)*	Sharpe ratio#
IDFC Premier Equity Plan A	20.39	0.55
ING Dividend Yield	18.92	0.56
BSL Dividend Yield Plus	18.49	0.56
Rel Regular Savings Equity	18.37	0.52
ICICI Pru Discovery Inst I	18.14	0.49
UTI Dividend Yield	17.54	0.55
ICICI Prudential Discovery	16.66	0.46
HDFC Top 200	16.66	0.51
Sund BNP Paribas SMILE Reg	16.55	0.47
UTI Master Value	15.97	0.45

*Compounded annual growth rate as on July 16, 2010;
#Sharpe Ratio as on June 30, 2010 Source: Value Research

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Date : 20-Jul-2010 Edition : Bangalore Page No.: 3b Page Name: My Money Size: 80.36 sq. cm

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LIVE RICH
FINANCIAL Chronicle

A four-point checklist to judge a mutual fund

1 Sharpe ratio measures risk-adjusted returns — whether returns notched up by a fund portfolio are due to smart decisions or excessive risk taken

2 Alpha is the measure of a fund manager's contribution to investment yield. It can tell you what portion of a fund's return can attribute to the fund manager's skills

3 Beta measures volatility of a fund portfolio in comparison with the broader market. A beta of 1 indicates that the portfolio value will move with the market.

4 Another indicator is R-Squared, which measures how closely your fund manager's returns match the returns of the benchmark with which it is compared

– FC Research Bureau