Investing in Banking Sector Mutual Funds: An Overview

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Abstract

I recommended to invest in Infrastructure mutual funds in India. This week, I am coming up with another set of sector based mutual funds which is banking sector mutual funds. There are several reasons why you should invest in banking sector mutual funds now to grow your money faster compared to equity funds. In this article, I would provide some insight about how the banking sector is expected to grow in future, risks involved and 3 promising banking and financial services sector mutual funds which you should invest in India now in 2014. you are already familiar about this, skip this section. Mutual fund schemes that invests purely in banking stocks and financial services stocks are termed as banking sector mutual funds. They invest in a variety of stocks like SBI, ICICI Bank, HDFC, HDFC Bank, etc. which are in banking and financial services sector. There are several positive things happening in the last 6 months, which can boost the banking and financial services sector in the coming years. Banking sector outlook looks positive. There are several positive indicators to prove this. With the new government formation, some of these indicators are going to happen. I am positive about Banking Sector Mutual funds and planning to invest in such funds through SIP and expecting good returns in next 3 to 5 years time frame.

Introduction

Investors in banking and financial services mutual funds (MFs) are a happy lot. With the category average returns at 85 per cent in the past year, these schemes have outperformed the benchmark Sensex and Nifty substantially. In fact, the category is the second-best performer among all segments in the past year, with the equity mid- and small-cap category alone exceeding it. While the performance has been stellar, should you enter any new or existing scheme now “If one is bullish on the economy, banking and financial services funds should be part of the portfolio,” says Manoj Nagpal, chief executive of Outlook Asia Capital. Though the overall outlook is bullish, there’s a catch. The difference in performance between public sector banks (PSBs) and their private counterparts, both in terms of share price and valuation, is vast. While many private lenders are expensive, trading at more than twice the book value (some such as HDFC Bank are trading at six times the book value), the number is one or even less for PSBs. Existing MFs have scored by investing in private banks. Most banking funds have private banks such as HDFC Bank, ICICI Bank and Axis Bank as their top holdings.

Recently, SBI MF launched its banking & financial services fund, an open-ended fund. Navneet Munot, chief investment officer, SBI MF, said the fund was positioned to take advantage of any acceleration in India’s economic growth. “We did not have a banking and financial fund in our portfolio and we have filled the product gap. It’s a large sector, with opportunities not only in banking but also in wealth management, housing finance, rating agencies, broking, NBFCs (non-banking financial companies) and MFIs (microfinance institutions). The financial services space is a large part of the economy and the companies have about 30 per cent weight in the Sensex and Nifty. There would be investors who would like to be part of that,” he said.

The fund will invest at least 40 per cent in financial services companies. While there’s no clarity on whether it will focus on private banks or PSBs, investors who want to invest in these schemes now have to consider these more carefully. “Valuations_are not cheap, which is why banking funds might not be able to replicate the performance of the past year," said Nisreen Mamaji, a certified financial planner. Before taking a call, investors who are unsure would do well to wait and see how the fund manager invests. This will help them decide whether the scheme is investing in expensive stocks or looking at cheaper banks. While the former might be a safer investment option, the returns might be limited. In the latter case, the scope of rising is much higher once issues such as non-performing assets are resolved. On the flip side, if these problems are allowed to fester, things could worsen. If you want to invest in the banking sector, an option is exchange-traded funds (ETFs), which mimic banking indices such as the BSE Bankex. The advantage of taking the ETF route is the expense ratios of these funds are about 50-200 basis points cheaper than actively-managed funds.

Banking sector funds have given retail investors sleepless nights this past year, on high volatility and poor performance. In 2013, they emerged as the worst category of mutual funds across all categories, returning -12.39 per cent, as compared to the BSE Sensex's 9.23 per cent gains. They also underperformed infrastructure funds (-6.87 per cent), according to data from Value Research. The big question now is whether retail investors should buy or stay invested in banking funds. Within the banking funds category, PSU bank or index funds underperformed significantly. The CNX PSU bank index lost around 31 per cent this past year, while the funds that mirror this index fund lost around 27 per cent. Actively managed funds faced negative returns, too, with most clocking returns of -12 per cent. A relatively better performer was ICICI Pru Banking and Financial Services Fund, which posted a negative return of -2.6 per cent.

Banks were faced with a very tough 2013 as the Reserve Bank of India's measures to defend the rupee in the middle of 2013 saw some tough liquidity tightening and interest rates increases. PSU banks also saw a fall in earnings of around 47 per cent (yoy), as against a strong earning growth of 23 per cent (yoy) for the private sector in the second quarter of FY14. The stress in PSU banks asset quality increased, with gross NPAs at 4.52 per cent. Private sector banks' asset quality was stable at 2.02 per cent. However, PSU banks have recovered from their lows in recent times.

Still, experts say the sector's volatility is expected to continue for a few quarters. RBI is likely to increase rates further if inflation does not ease. However, the overall outlook for 2014 looks much better, as the asset quality is expected to stabilise, while the rupee is showing signs of stabilising. Says Vaibhav Agrawal, banking analyst, Angel Broking: "The next year is going to be much better for the banking stocks, with liquidity pressures and interest rates having eased." Further, bank deposits are expected to grow as interest rates rise, while credit growth will likely slacken thus reducing the net interest margins. Bank deposits grew at 17 per cent year-on-year as on December, while credit growth grew 15 per cent. Experts advise if investors can stomach the volatility of the PSU banks in the next few quarters, they could remain invested in these. Says Daljeet Kohli, head of research, India Nivesh: "In the past year, PSU banks saw a downgrading due to asset quality slippages. Now most of them are quoting at very low price to book values, which means any good news from them could result in a better stock performance."

If you already have some exposure to PSU banks exchange-traded funds, experts' advise to remain invested for now, as the worst seems to be behind. But avoid fresh exposure, as the sector is still volatile and the choppiness will continue for a while. Or invest very little in this space. Private sector banks, on the other hand, are better placed on liquidity and are logging better growth rates, beside trading at attractive valuations. Says Agrawal: "Most private banks are better placed, should manage to hold on to their growth rates and are also going cheaper." Hence, investors could continue to hold or invest small amounts in actively managed banking funds, with a large chunk in private banks. Investors have to, however, see the recovery in the investment cycle, which means holding on to these funds for at least a one or two-year horizon.

I recommended to invest in Infrastructure mutual funds in India. This week, I am coming up with another set of sector based mutual funds which is banking sector mutual funds. There are several reasons why you should invest in banking sector mutual funds now to grow your money faster compared to equity funds. In this article, I would provide some insight about how the banking sector is expected to grow in future, risks involved and 3 promising banking and financial services sector mutual funds which you should invest in India now in 2014. you are already familiar about this, skip this section. Mutual fund schemes that invests purely in banking stocks and financial services stocks are termed as banking sector mutual funds. They invest in a variety of stocks like SBI, ICICI Bank, HDFC, HDFC Bank, etc. which are in banking and financial services sector. There are several positive things happening in the last 6 months, which can boost the banking and financial services sector in the coming years.

Concept

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them. Thus, a Mutual Fund is the most suitable investment for the common person as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost. The flow chart below describes broadly the working of a mutual fund. The Security And Exchange Board Of India (Mutual Funds) REGULATIONS,1996 defines a mutual fund as a " a fund establishment in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments." Mutual Funds have been a significant source of investment in both government and corporate securities. It has been for the decades the monopoly of the state with UTI being the key player with invested funds exceeding Rs. 300 bn. (US $ 10 bn.). The state owned insurance companies also hold a portfolio of stocks. Presently, numerous mutual funds exist, including private and foreign companies. Banks - mainly state owned too have established Mutual Funds (MFs). Foreign participation in mutual funds and asset management companies permitted on a case-by-case basis.

New Government focus on Infrastructure growth: Like I indicated in my last week's article, new government is expected to put major focus on Infrastructure growth. While construction and Infra companies are going to be the direct beneficiaries of this, indirectly banking and financial services sector would get benefited with this move. The funds required for such Infra development would pass thru the banks/financial services sector. This would benefit the banking sector in next 3 to 5 years time.

Banks performance improved: Large banks have been performing well in terms of financials. Non-Performing Assets are under control. Under the tight controls from the RBI, the banking sector is going to perform well in the coming years.

McKinsey expects good growth in next 6 years: McKinsey, a global management consulting firm has released a report few months back about the banking sector. The report titled “Reimagining Banking in India”. This report indicates that by 2020, Indian Banking Sector will be shaped by a strong interplay between the external environment and actions by policy makers and banks. They have outlined three potential scenarios that might emerge as a result, and have qualitatively and quantitatively described the differences in inputs and outcomes. This report provides a positive outlook on banking sector in coming years.

FDI in the banking sector could increase: There are several requests to Govt. In India to increase FDI in the banking sector. This would help more inflow of funds to banks and such funds can be used for bank’s business growth.

Experts say that banking sector may create 20Lakh new jobs:

There are several experts who are indicating that the banking sector can create 20L new jobs in next 5-10 years and 2014 would be starting point for that (Source: Thehindubusinessline). Unless there is business demand, such high employment sources may not be possible. This would indicate that the banking sector would continue to flourish for next few years.

New Banking Licenses to boost banking sector:

RBI has issued new banking licenses recently. These new banks are expected to tap new emerging markets and would do innovatively to enter the market. This raises hopes on the banking sector.

Risks involved in banking sector funds:

High Risk:

Sector funds are always high risk investments. In case sector is in a downturn, you could see huge falls in your capital investment. You might be seeing such downturn in FMCG funds now.

Tighter controls of RBI:

While it is good to have tight controls from RBI, some of the measures from RBI would not help the banks to grow. We have seen several instances in the past about RBI takes such measures time to time.

NPAs can increase in the future:

Though Non Performing Assets (NPA's) are under control now, any increase in defaulter of loans in the future can reduce the profits of the banks and financial services companies. We could see this clearly in 2007 Global Financial Crisis where defaulters increased drastically in US and several banks and financial services companies collapsed.

Three Banking Sector Mutual Funds to Invest now

Now, I would come to a final point about choosing best banking mutual funds in India. Based on past 5 years performance, Valueresearchonline rating, AUM, we have chosen 3 promising banking sector mutual funds which you can invest in India now. These banking mutual funds are expected to double your money in next 3 to 4 years or expected to provide 15%+ annualized returns in next 5 years.

Top 3 Banking and Financial Services Mutual fund

Mutual Fund Scheme	Crisil Rank	Value Research Rating (Out of 5)	AUM (Rs Crores)	6mth	1yr	3yr	3yr
ICICI Pru Bkg & Fin Serv-RP(G)	Not Ranked	5 Star	235.32	37.1%	41.5%	19.7%	22.8%
Reliance Banking Fund (G)	Not Ranked	4 Star	1357.9	40.1%	34.9%	14.8%	21.1%
UTI Banking Sector (G)	Not Ranked	3 Star	300.52	30.0%	25.1%	11.0%	17.7%

Source: Moneycontrol.com and Value Research Onlin. Data as on 7-Jun-2014

Performanceof Mutual Funds in India

Let us start the discussion of the performance of mutual funds in India from the day the concept of mutual fund took birth in India. The year was 1963. Unit Trust of India invited investors or rather to those who believed in savings, to park their money in UTI Mutual Fund. The performance of mutual funds in India in the initial phase was not even closer to satisfactory level. People rarely understood, and of course investing was out of question. But yes, some 24 million shareholders were accustomed with guaranteed high returns by the beginning of liberalization of the industry in 1992. This good record of UTI became marketing tool for new entrants. The expectations of investors touched the sky in profitability factor. However, people were miles away from the preparedness of risks factor after the liberalization. The Assets under Management of UTI was Rs. 67bn. by the end of 1987. Let me concentrate about the performance of mutual funds in India through figures. From Rs. 67bn. the Assets Under Management rose to Rs. 470 bn. in March 1993 and the figure had a three times higher performance by April 2004. It rose as high as Rs. 1,540bn. The net asset value (NAV) of mutual funds in India declined when stock prices started falling in the year 1992. Those days, the market regulations did not allow portfolio shifts into alternative investments. There was rather no choice apart from holding the cash or to further continue investing in shares. One more thing to be noted, since only closed-end funds were floated in the market, the investors disinvested by selling at a loss in the secondary market. The performance of mutual funds in India suffered qualitatively. The 1992 stock market scandal, the losses by disinvestments and of course the lack of transparent rules in the whereabouts rocked confidence among the investors. Partly owing to a relatively weak stock market performance, mutual funds have not yet recovered, with funds trading at an average discount of 1020 percent of their net asset value. The measure was taken to make mutual funds the key instrument for long-term saving. The more the variety offered, the quantitative will be investors. At last to mention, as long as mutual fund companies are performing with lower risks and higher profitability within a short span of time, more and more people will be inclined to invest until and unless they are fully educated with the dos and don'ts of mutual funds.

Conclusion:

Banking sector outlook looks positive. There are several positive indicators to prove this. With the new government formation, some of these indicators are going to happen. I am positive about Banking Sector Mutual funds and planning to invest in such funds through SIP and expecting good returns in next 3 to 5 years time frame. Mutual funds are funds that pool the money of several investors to invest in equity or debt markets. Mutual Funds could be Equity funds, Debt funds or balanced funds. Fund are selected on quantitative parameters like volatility, FAMA Model, risk adjusted returns, and rolling return coupled with a qualitative analysis of fund performance and investment styles through regular interactions / due diligence processes with fund managers.

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