PGIM
India Mutual Fund

The Sequence of Returns

Ajit Menon
CEO

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Dear Investors and Partners,

Many first-time investors who invest in equity markets via equity-oriented mutual funds often complain of high market volatility and having a bad experience and as a result their participation remains low. However in my opinion, this is a behaviour challenge more than anything else and this can be solved to a great extent by focusing on the sequence of risk and expected return. Let me elaborate on what I mean by this.

Many first-time investors in India have been conditioned to think about investing from their childhood days in a certain manner. The fixed interest bearing nature of traditional investment means that the returns are very predictable year on year and as a result there are no apparent risks in the traditional investment products. Many investors traditionally don't think about inflation-adjusted returns or real returns and thus the perception of risk is low, even though the rate of return may also be lower. Due to this conditioning perhaps many first-time investors tend to look at market-linked investment avenues in much the same manner and perhaps may not fully understand the relationship between expected return and the risk undertaken for any investments.

For example, let's assume a father who wants to save for his daughter's higher education in a pedigree college and the corpus is required 15 years from now. Let's assume the cost at that time would be Rs 2 crore. This means that the investor can open a recurring deposit with any bank which provides 7% interest p.a and he has to deposit Rs 743,825 at the beginning of each year for the next 15 years and he will end up with his desired corpus. This is really smooth and a predictable solution. However if there are issues like interest rate in the economy going down and as a result banks not offering 7% interest rate for 15 years any longer, or if there is an affordability issue in terms of saving approx. Rs 7.4 lakhs each year for a specific goal, then looking at some alternatives become imperative. In this scenario, an investment product which can provide higher yield and thus lower annual installments can serve the purpose well. However there is a small problem. *(The above illustration is for understanding of the concept of investments and are not scheme returns).*

The sequence of return in a market-linked product is not linear as compared to a traditional recurring deposit. If for example in the very 1st year the markets drops by -15%, then the required rate of return for next 14 years goes up to 7.25% from 7.00%, keeping installment amount constant. If we assume that equity markets deliver 7.25% return YoY i.e. no volatility in returns, and there are no further hiccups then the target will be achieved. Let's also hypothetically look at scenario 2 and assume that in the next 14 years there is one particular year say the 10th year, when the markets delivers above-average return of 20%. In this case, the target corpus will be achieved in the 14th year itself. Of course, this can work the other way too, and there could be a major drop in the markets just as one is nearing the tenure of one's goal which can prevent in achievement of the final corpus. This is what happened with many investors during March 2020, when Covid related disruptions led to a significant drop. Thus, as a thumb rule, it is advised to keep shifting to lesser risky investment options as one approaches the target date. However, this nuance has to be built-in right when one is drawing the financial plan, as each individual's situation is unique. A trusted financial advisor can help immensely in setting up the plan and then an ongoing navigation and review. *(The above illustration is for understanding of the concept of investments and are not scheme returns).*

Overall, I think the non-linearity of returns is something many traditional Indian investors are not accustomed too yet and thus they do not fully fathom the benefits of long term compounding and disturb this at the first instance of negative returns and heightened volatility in the market. As I said earlier, this is more of a behaviour challenge and there are two solutions which have emerged in the Indian mutual fund space. First is the emergence of the Balanced Advantage Funds category, which by virtue of their product design, endeavour to smoothen out this market volatility and provide investors with a journey that they can be reasonably comfortable with in terms of risk-reward. Second is the focus on goal-based investing and asset allocation.

Let's take an illustration again to understand this better. Assume an investor Mr. A who started investing in 2010 and based on past 1 years returns of various indices, he decided to invest in Smallcap index, as it was the top performing index. He stays invested for the next 3 years and at the end of 3rd year in 2013-beginning, he assesses his portfolio return and finds that Smallcap index has underperformed the markets and observes that a sectoral index of Financial services has been doing well and decides to switch to that category instead and stays invested for next 3 years again. After 3 years, when it's time to review his investment in 2016-beginning, Mr. A finds out that infact it was the Smallcap index which has again outperformed all the other categories. Mr. A realizes his mistake and switches back from Financial Services index to Smallcap index. The cycle repeats and in his next review at the beginning of 2019, its once again the same pattern. Smallcap index has underperformed and this time another sectoral index of FMCG has outperformed. In a confused state of mind, he decides to chase returns and shifts to FMCG index, hoping it's different this time. However, in beginning 2022, the FMCG index turns out be the underperformer. What's your guess for the next 3 years till 2025 and if you were in Mr. A's place, what would you do now?

On the other hand, let me give you the data point for the last 12 years for Nifty 500 Index (benchmark for most Flexicap funds) and CRISIL Hybrid 50:50 Moderate Index (benchmark for most balanced advantage funds). These two indices basis last 12 years CAGR, would have outperformed Mr. A by a fair margin. Nifty 500 TRI Index had generated returns of 12.2% and Crisil Hybrid 50:50 Moderate Index had generated returns of 10.7% on a CAGR basis, whereas Mr. A's strategy would have generated returns of 7.4%. *(Source: ICRA MFIE. The above is for understanding of the concept of investments and are not scheme returns).*

In conclusion, a simple buy-and-hold strategy, perhaps can work better. I have a feeling that this is the story for a lot of investors, because they miss out on the importance of sequence of return and risk and disturb it at regular intervals and expose the overall portfolio to higher volatility which eventually results in sub-optimal solutions.

Stay safe & happy investing.

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