Investment Outlook & NAFA Funds' Performance

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How to Select a Mutual Fund

The mutual fund industry has grown exponentially over the last five years. Presently, thirty asset management companies (AMCs) are operational, managing a total of sixty-nine funds. Of these, twenty-two funds are closed-end, while the remaining are open-end. Twenty three are equity funds, five balanced and nineteen income funds. All this is creating confusion in the minds of the investors, as how to select a mutual fund. This month's article provides some tips to investors in this regard.

Sponsors: The starting point towards this exercise for an investor is to invest with an asset management company whose sponsors, the investor is comfortable with. Trust is the most important criterion before one invests his / her money. Several financial institutions have established their asset management companies over the last few years, enhancing investors' trust level with the industry.

Rating of the AMC: Second, an investor should examine the "Asset Management Quality" rating of the AMC. PACRA and JCR-VIS rate asset management companies. The rating agencies examine the quality of the sponsors, management, operations, risk management and asset management systems before assigning a rating to an AMC. Presently no AMC is rated as AM1 (highest asset management quality). Seven AMC's are rated AM2 (high management quality), eleven AMCs are rated AM3 (good management quality), while two are rated AM4 (adequate management quality). None of the AMCs is presently rated AM5 (weak management quality). Investors can get detailed information on the rating of AMCs by visiting the websites of PACRA and JCR-VIS Rating Agency.

Type of Fund: Low-risk investors seeking an expected return of around 10% per annum should invest in Income / Cash funds, medium-risk investors may choose Balanced / Multi-asset funds, while high-risk investors targeting a 20% per annum or higher return may invest in stock funds. Open-end funds are preferable as they do not trade at a discount to their net asset values.

Performance of the Fund: The next important point is to analyze the performance of funds in the same risk class. It will, for example, not make sense to compare performance of a stock fund with an income fund. Funds performance should be compared over the same time period and net of all expenses incurred by the Fund. The returns should include both dividend yield and capital gains / losses over the defined period.

A Fund's performance should always be compared with that of a benchmark. For a stock Fund the relative benchmark is the KSE 30 Index or KSE 100 Index. If an equity Fund states that it has provided a 30% return to its investors over the last year, this does not say much whether the Fund has performed well or not. If the stock market has risen by 40% during the last year the Fund has actually performed poorly, and if the stock market has risen by 20% during the last year, the Fund has performed very well. Similarly, a stock Fund may have experienced a negative return of 10% during a year and still be a good Fund if the stock market has dropped by 20% during the same period. The rating agencies provide star rating to funds which range from five star (superior performance) to a single star (poor performance).