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PMS investment is too risky, opt only if you have a large portfolio

Only those who have a large portfolio and the ability to select the right fund managers should opt for it

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A key conclusion one can derive from the S&P Indices Versus Active Funds (SPIVA) India reports is that the average mutual fund manager does not beat the index. So, the only reason a person should invest with an active mutual fund manager is if he believes that the latter is one of the top few (say, 1 per cent) public market investors in India managing money for others. Similarly, the only reason one should invest with a Portfolio Management Service (PMS)manager is if one believes that he is among the top few investors.

Around 140,000 Indian investors have invested about Rs 110,000 crore in 200-plus PMS. The assets under management (AUM) of all mid-cap and small-cap mutual funds put together is nearly the same. Most of these investors in PMS don't have the wherewithal to take so much risk. And most of them also do not possess the ability to evaluate whether a PMS manager is among the top few investors. Let's examine each of these aspects.

Limited risk-taking ability

Mutual funds are tightly regulated products and you can invest even a few thousand rupees in them. PMS are akin to less regulated mutual funds.Hence, the regulator has set a minimum investment limit of Rs 25 lakh in PMS. The regulator hopes that if the investor has Rs 25 lakh to invest in one PMS, then he probably knows what he is doing.

Issues investors face

- Quality of data available in the public domain is poor
- Even if they have the ability, investors will find it difficult to select a top-quality PMS manager using such data
- Investors should not put more than 10 per cent of their net worth in a high-risk product such as PMS
- They also need to diversify across three or four PMS
- All this means an investor's net worth needs to be very high to invest in PMS

Unfortunately, the high upfront commissions on PMS (up to 5 per cent of the investment amount) tempts many banks and distributors to hard-sell it to investors who don't know what they are doing. One hears of PMS investment of Rs 25 lakh being sold to a 60-year-old who has just retired and has a net worth of Rs 75 lakh. Some PMS are very volatile and risky because they invest in micro-cap shares and have a very concentrated portfolio. One highly visible PMS has lost 57 per cent of its value since January 2018.

Inability to evaluate managers

The poor quality of publicly-available data makes it very difficult to identify a top investor among the 200-plus PMS managers. Let me enumerate ten key impediments that an investor is likely to face in selecting a quality fund manager. One, monthly PMS performance data is available in the public domain only since January 2013. This amounts to only six-and-a-half years of data. It is difficult to draw robust conclusions based on such a short track record. Two, some popular PMS strategies have been in operation for a very short period, say, two years. Three, for some large PMS, including one of the largest, the monthly data in the public domain is blank or missing for several years. Four, in a few cases the data is — accidentally or due to carelessness — completely and obviously wrong.

Five, PMS managers may tell you to focus on one out of their large number of strategies,which reported a good performance. It could, for instance, be their mid-cap growth strategy. But one out of many strategies may have done well purely due to luck or randomness. Six,private-performance data about a PMS or strategy should be taken with a pinch of salt. This is true even if a chartered accountant has signed off on the data. Seven, while providing private-performance data, some PMS provide aggregate performance for all clients. But a majority of PMS provide the performance of a 'model portfolio'. Theoretically, a PMS manager can make the 'model portfolio' performance look slightly better than the aggregate performance. Hence,'model portfolio' performance is less reliable.

Eight, most PMS reports to investors and to the regulator incorrectly benchmark their performance to price return indices rather than to the correct total return indices (which include dividends). So, the PMS performance looks better than it actually is. Nine, a PMS is a less tax-efficient product than a mutual fund. So, you have to estimate the post-tax returns (depending on the timing of each transaction, gains could be long- or short-term). Ten, those PMS that pay a high upfront commission to distributors will charge you an exit load of up to 3 per cent of the amount invested. So, you must understand all the fine print before you invest.

There are many other more technical issues. For example, it is possible for a PMS (or mutual fund) to have positive returns since inception but for almost all its investors to have lost money. And, it is possible to engineer a portfolio to generate good returns for many years, but in a severe market crash the portfolio value may fall to almost zero. Since a severe market crash may happen only once in one or two decades, the PMS manager will earn an attractive fee till then.

Is your portfolio large enough?

Let's assume that you are determined to invest in a PMS. You believe that under ideal circumstances you have the skill to select a top-quality investor. But the poor quality of data forces you to identify a set of four PMS managers who are potential top-three investors. You decide to invest Rs 25 lakh with each of them, or a total of Rs 1 crore. Ideally, you should not put more than 10 per cent of your net worth at such high risk and in a product that is not as tightly regulated as mutual funds. Hence, your net worth should be at least Rs 10 crore.

All other investors are likely to be better off investing in mutual funds, particularly index funds. They will benefit from the regulator limiting the fees and commissions of mutual funds and forcing them to disclose their long-term performance data.

Most investors like exotic investment products because they provide one more thing to boast about at cocktail parties. The law of no-free-lunch hints that, all else being equal, the greater the boasting value of an investment product, the lower is the return one is likely to earn from it. Investors should treat investing with the same degree of seriousness with which they treat other important decisions in life. While selecting a spouse, it is best to stay away from someone too complex and stick to someone who is relatively easier to understand. The same holds true for selecting investment products.

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