Quadrant II - Notes

Paper Code: COG142

Module Name: Floating Rate Schemes and Portfolio Churning in Liquid Funds

Most often investors churn their portfolios very frequently because they are being advised by their mutual fund agent/advisor to do so. Read this space to know how exiting from one fund and subsequently reinvesting in another can have a detrimental impact on the returns.

As investment avenues, mutual funds offer benefits like diversification and professional fund management, among others. However, these benefits come at a cost i.e. if you wish to invest in a mutual fund then you will have to bear the stipulated charges as well. For example, there are annual (recurring) charges expressed in terms of the expense ratio, also charges like exit loads are to be borne if you exit within a stipulated period and the newly introduced transaction charge while buying in a mutual fund scheme. Over longer time frames, these charges can have a significant impact on the returns clocked by the mutual fund scheme. While there is no way to avoid these expenses, you can certainly rationalize them by investing in the right avenues and avoiding a frequent churn in your portfolio.

Simply put, churning the mutual fund portfolio means buying and selling mutual funds frequently. This is the reverse of the recommended method of investing i.e. making investments and staying invested therein for the long-term. Investors generally churn their portfolios because they are advised by their mutual fund agent/advisor to do so; the agent sometimes even passes back to them a portion of the commission he earns as an incentive to induce the churn. Alternatively the desire to clock higher returns by investing in a better performing fund triggers a portfolio churn. Finally, many investors have inexplicable urge to invest in funds with lower Net Asset Values (NAVs) or New Fund Offers (NFOs) priced at Rs 10 that leads to a churn in the portfolio.

Whatever be the case, it should be understood that exiting one fund and subsequently reinvesting in another could involve additional costs in the form of exit load and transaction charges. And over the long-term these costs add up and have a detrimental impact on the returns.

The impact of portfolio churning

If your advisor advises you to frequently churn your mutual fund portfolio, then it is pertinent for you to be aware of the costs involved. A simple exercise entailing some calculations can help you quantify the negative impact of a portfolio churn. But before that, let us establish the ground rules for the exercise.

1. Decide the amount that you wish to invest and the investment tenure. For example, let's assume that you make an initial investment of Rs 100,000 for a 5-Yr period.

2. Then decide on the annual rate of return that you expect to earn from the investment. In this case, let's assume the rate to be 15.00% per annum.

3. Finally, account for the exit loads and transaction charge that you will have to bear in the process of redeeming your monies from one fund and investing the same in another. Let's assume 1% as the total exit load and Rs 100 as the transaction charge.

To quantify the impact of churning on returns, let's calculate considering two options, A and B.

Option A: Investment grows without churning the portfolio

Compute the maturity value for the investment of Rs 100,000 (Rs 100 incurred as transaction charge on investment) at 15.00% per annum over a 5-Yr period. In this case, the portfolio is not churned at all throughout the investment tenure. As a result, the maturity value will be Rs 200,935.

Option B: Portfolio is churned once every year

In this case, the maturity value of the investment is computed, assuming that the portfolio is churned once every year (i.e. 5 times over a 5-Yr investment tenure). Of course, on account of the churn, loads and charges will have to be borne in every transaction. Assuming the same rate of return, the maturity value will be Rs 192,425.

The difference between Option A and Option B is Rs 8,483. The impact of annual churning of your mutual fund portfolio over a period of 5 years is around 8.5% of your initial investment. Rs 8,483 can be termed as the additional amount earned by selecting Option A or as the loss incurred by selecting Option B.

It should be noted that while computing the impact of churning the portfolio, some crucial assumptions have been made, for example the rate of return on the investment. Now the same isn't necessarily fixed and is bound to fluctuate over a period of time thus impacting the result of the calculation. Also the number of times you choose to churn the portfolio is an individual choice. Finally, the exit loads may vary across funds and fund houses as well and depending on your holding period; and most importantly the actual performance of the schemes that you choose to buy and sell. Hence the likelihood of the actual result of the portfolio churn being different vis-a-vis the result displayed in the above table cannot be ruled out. However, this calculation in reality will undeniably help you estimate the impact of frequently churning the portfolio.

In conclusion, the negative consequences of regularly churning the portfolio are undeniable. The onus to not get carried away by 'motivated' sales pitches of the investment advisor and make an informed decision on mutual fund investment lies with you.