

Consultation Paper on disclosure of Risk Adjusted Return by Mutual Funds

A. Objective

The objective of this consultation paper is to seek comments / views from the public on the proposal regarding disclosure of Risk Adjusted Return of the portfolio of a Mutual Fund scheme (MF Scheme), thereby enabling informed investment decision by the investors.

B. Background

1. The return on investment is a major factor attracting investors to invest in any MF scheme, and is highlighted by the Asset Management Companies (AMCs), while marketing respective schemes.
2. The various provisions of the SEBI (Mutual Funds) Regulations, 1996 (“MF Regulation”) and Master Circular *inter – alia* mandate filing of periodic information regarding schemes’ performance i.e. return on investment, with SEBI through various documents including scheme Annual Report, scheme’s annual and half yearly financial results, Scheme Information Document (SID), Key Information Memorandum (KIM) as well as on the websites of Association of Mutual Funds in India (AMFI) and respective AMCs.
3. In addition to above, disclosures of scheme returns are also made by AMCs in schemes’ abridged Annual Report, report to Trustee by AMCs, fund factsheets, investor account statement, product notes etc. Thus, appropriate disclosure pertaining to scheme returns to investors are presently made, mandatorily or voluntarily, in various documents / disclosures by AMCs.
4. Notwithstanding the above, it is felt that the “Risk Adjusted Return” (RAR) of a scheme portfolio represents a more holistic measure of the scheme’s performance because it quantifies the amount of return generated by a MF scheme for each unit of risk taken to achieve that return.
5. However, the extant regulatory framework does not mandate disclosure of RAR along with the returns of a MF scheme. Further, there is no uniform practice followed by AMCs regarding disclosure of RAR of their schemes.

C. Current industry practice

Based on the information provided by AMCs, the following is observed regarding disclosure of risk adjusted return of MF schemes:

1. Not all AMCs disclose the RAR for all the categories of MF schemes managed by them.
2. Several AMCs disclose the RAR pertaining to a scheme in respective monthly fund factsheets, marketing material etc.
3. AMCs do not follow a uniform methodology for calculation of RAR, frequency of disclosure of the same as well as frequency of NAVs used for calculation of the same.
4. Not all AMCs annualise the volatility (standard deviation) used to calculate the RAR of their schemes.
5. A summary of number of AMCs disclosing RAR of open ended schemes managed by them is placed as under:

Sl No.	A - Category of scheme	B - No of AMCs having schemes under Category at Column A	C - No. of AMCs disclosing RAR across various schemes under Category at Column A
1	Equity	39	33
2	Debt	39	26
3	Hybrid	36	27
4	Solution oriented	20	8
5	ETFs/ Index Funds	29	17
6	FoFs	29	9

D. Issues for Public Consultation

The aforesaid issue was placed before the Mutual Fund Advisory Committee ('MFAC') for deliberation. Considering the recommendations of MFAC, comments on the proposal for mandatory disclosure of RAR along with the return of a MF scheme, are sought as follows:

1. Disclosure of RAR by Mutual Fund schemes

1.1. Considering the significance of volatility of performance in determining the suitability of MF schemes, it is desirable that the RAR of the scheme is disclosed along with disclosure of its scheme performance. Information Ratio (IR) is an established financial ratio to measure the RAR of the scheme portfolio. It is often used as a measure of a portfolio manager's level of skill and ability to generate excess returns relative to a benchmark and it also attempts to identify the consistency of the performance by incorporating a tracking error, or standard deviation component into the calculation.

1.2. The IR is the ratio of Tracking Difference (TD) to Tracking Error (TE) of a scheme portfolio over a given period of time.

$$IR = (TD/TE)$$

While the TD is the excess return of the portfolio w.r.t its benchmark, the TE refers to the volatility/ standard deviation of the excess return.

Volatility or Standard Deviation is a statistical measure representing the deviation of return of a security around its mean return, therefore denoting riskiness of the security. More volatility denotes lesser consistency of return and higher riskiness of the security and vice versa.

Therefore, IR of a MF scheme portfolio shall provide information regarding the excess return w.r.t its benchmark while incorporating the risk taken relative to the benchmark to achieve the same, thus representing the RAR of an MF scheme.

1.3. IR is a relative measure that can be used to compare the RAR across different MF schemes under a particular category with a common reference benchmark. A scheme with higher IR shall indicate a better risk adjusted performance w.r.t other schemes, subject to both the schemes comparing their performances to the same benchmark under a particular category.

1.4. For a given volatility of excess return, a scheme with higher IR indicates higher excess return achieved by that scheme as compared to other schemes for the same level of risk taken vis-à-vis the common benchmark. Conversely, for a given percentage of excess return, a scheme with higher IR indicates that lesser risk is taken by that scheme as compared to other schemes to achieve the same percentage of excess return vis-à-vis the common benchmark. An illustration explaining the above is placed at **Annexure A.**

1.5. In view of the above, IR is an established tool to evaluate how efficiently the portfolio returns are achieved relative to the level of risk taken, thereby providing a more comprehensive assessment of the investment performance.

1.6. Considering the growth of the industry and the role that disclosure of IR can play in investment decision of the investors, Mutual Funds/ AMCs may be mandated to disclose the IR of a scheme portfolio along with the return of its respective benchmark, wherever the return of the said scheme is disclosed i.e. in all scheme related documents / disclosures as mandated under the present regulatory framework for mutual funds. Further, AMCs may also be mandated to disclose IR and benchmark returns, wherever scheme performance is voluntarily disclosed such as on digital applications, marketing materials, product notes, emails etc.

Consultation Proposal 1

Please consider the proposal at D (1) above and provide comments on the proposal for disclosure of IR as a measure for disclosure of RAR along with the scheme's performance.

2. Methodology for calculation of IR for different categories of Mutual Fund schemes

Currently, due to absence of any mandate on disclosure of volatility of returns, the same is not disclosed by most of the AMCs and wherever disclosed, varied methods are followed for calculation of volatility/ sensitivity. In order to bring

uniformity across different MFs, the following measures may be taken into account for calculation of IR for different categories of MF schemes.

2.1. Equity oriented Mutual Fund schemes, Hybrid schemes, Solution oriented schemes and Fund of Funds

IR may be calculated as under:

$$\text{IR} = \frac{\text{Portfolio Rate of Returns} - \text{Benchmark Rate of Returns}}{\text{Standard Deviation of Excess Return}}$$

Excess Return= Portfolio Rate of Returns – Benchmark Rate of Returns

Benchmark used in the formula may be the Tier 1 benchmark currently used by the equity oriented mutual fund schemes.

2.2. Debt oriented Mutual Fund schemes

The methodology for calculation of IR for debt oriented MF schemes may be same as that mentioned at paragraph 2.1 above except that the benchmark used in the aforesaid formula may vary depending on the category of the debt oriented scheme and the respective Tier 1 benchmark for each category.

2.3. ETFs and Index Funds

For ETFs and Index funds, present requirement for disclosure of Tracking Error (TE) and Tracking Difference (TD), may be considered as sufficient to meet the volatility disclosure requirement.

An illustration explaining the methodology to calculate IR is placed at **Annexure A.**

Consultation Proposal 2

Please consider the proposal at paragraph D (2) above and provide comments with rationale regarding the methodology discussed above for calculation of IR for each category of Mutual Fund.

3. The IR of MF schemes may be calculated and disclosed on daily basis on the websites of respective AMCs, along with on the website of AMFI. The same may also be disclosed in the SID and KIM of a scheme along with all other platforms.
4. Currently, for schemes, which are in existence for less than six months, disclosure of past performance is not mandatory. Accordingly, for such schemes, disclosure of the IR may also not be required. Further, if a scheme has been in existence for more than six months but less than one year, IR based on annualized return of the scheme for the past 6 months may be disclosed in line with the current guidelines along with disclosure of performance.

Consultation Proposal 3

Please consider proposals at paras D(3) – D(4) above and provide your comments separately for each proposal along with rationale.

5. The format for disclosure of IR

The format for disclosure of IR on the website of AMFI, website of AMCs, SIDs and KIMs may be prepared by AMFI in consultation with SEBI. However, a specimen of the format is as under:

NAV Regul ar	NAV Dire ct	Return 1 Year (%) Regular	Return 1 Year (%) Direct	Return 1 Year (%) Benchmark	IR 1 Year (%) Regular	IR 1 Year (%) Direct	Daily AUM (Cr.)
							
							

Consultation Proposal 4

Please consider proposal at paragraph D (5) above and provide your comments along with rationale.



E. Public Comments

1. Public comments are invited for the proposals at paragraph D(1)- D(5) above. The comments/ suggestions should be submitted by any of the following modes latest by July 19, 2024 :-

1.1. Online web-based form

1.1.1. The comments may be submitted through the following link:

<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>

1.1.2. The instructions to submit comments on the consultation paper are as under:

- a. Before initiating the process, please read the instructions given on top left of the web form as “Instructions”.
- b. Select the consultation paper you want to comment upon from the dropdown under the tab – “Consultation Paper” after entering the requisite information in the form.
- c. All fields in the form are mandatory;
- d. Email Id and phone number cannot be used more than once for providing comments on a particular consultation paper.
- e. If you represent any organization other than the types mentioned under dropdown in “Organization Type”, please select “Others” and mention the type, which suits you best. Similarly, if you do not represent any organization, you may select “Others” and mention “Not Applicable” in the text box.
- f. There will be a dropdown of Proposals in the form. Please select the proposals one- by-one and for each of the proposal, please record your level of agreement with the selected proposal. Please note that submission of agreement level is mandatory.
- g. If you want to provide your comments for the selected proposal, please select “Yes” from the dropdown under “Do you want to comment on the proposal” and use the text boxes provided for the same.



- h. After recording your response to the proposal, click on “Submit” button. System will save your response to the selected proposal and prompt you to record your response for the next proposal. Please follow this procedure for all the proposals given in the dropdown.
- i. If you do not want to react on any proposal, please select that proposal from the dropdown and click on “Skip this proposal” and move to the next proposal.
- j. After recording your response to all the proposals, you may see your draft response to all of proposals by clicking on “Check your response before submitting” just before submitting response to the last proposal in the dropdown. A pdf copy of the response can also be downloaded from the link given in right bottom of the web page.
- k. The final comments shall be submitted only after recording your response on all of the proposals in the consultation paper.

1.1.3. In case of any technical issue in submitting your comments through web based public comments form, you may contact the following through email with a subject “Consultation Paper on disclosure of Risk Adjusted Return by Mutual Funds”.

- i. Mr. Lakshaya Chawla, Deputy General Manger(lakshayac@sebi.gov.in)
- ii. Ms. Kritika, Assistant Manager (kritika@sebi.gov.in)

Issued on: June 28, 2024

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(End of Consultation Paper)

Annexure A

1. Methodology for calculation of the Information Ratio (IR)

1.1. The IR is the ratio of Tracking Difference (TD) to Tracking Error (TE) of a scheme portfolio over a given period of time.

$$IR = (TD/TE)$$

1.2. TD or, Excess Return = Portfolio Returns less Benchmark Returns

TD for a given period shall be calculated as the annualised average of the daily excess returns of the portfolio w.r.t its benchmark in a particular category. TD shall be annualized by multiplying the average of the daily excess returns by 252.

Daily portfolio returns are calculated through logarithmic function of present day's NAV with previous day's NAV using the formula as under:

$$R_t = \ln (NAV_t / NAV_{t-1})$$

Where, R_t = Return on t^{th} day

NAV_t = NAV on t^{th} day

NAV_{t-1} = NAV on $(t-1)^{\text{th}}$ day

Similarly, daily benchmark returns shall be calculated using the aforesaid method.

1.3. TE = Annualized population volatility or, standard deviation of the excess returns of the portfolio w.r.t its benchmark.

TE shall be calculated using the daily returns of the portfolio and the benchmark and the daily returns shall be calculated using the methodology provided in Paragraph 1.2 above.

Annualised SD is calculated by multiplying SD of daily excess return with square root of 252.

1.4. Annualized IR shall be calculated basis the data of 1 year, 3 years, 5 years and 10 years separately.

2. As per the above methodology, a comparison of risk adjusted performance of few MF schemes basis back testing of actual returns has been carried out for illustration purpose, which is summarized as under:

2.1. Illustration 1

Let's assume there are two funds, T and S under small cap category. The data w.r.t the IR of these 2 funds calculated basis the NAV of these 2 funds and their common tier -1 benchmark over the last 1-year period are tabulated below:

Fund T		Fund S	
Excess Return (TD)	7.2 %	Excess Return (TD)	4.7%
Annualised SD (TE)	7.42%	Annualised SD (TE)	7.52%
Information Ratio (TD/TE)	0.97	Information Ratio (TD/TE)	0.63
Minimum Excess Return	-3.18%	Minimum Excess Return	-3.07%
Maximum Excess Return	3.03%	Maximum Excess Return	3.09%
Median Excess Return	0.01%	Median Excess Return	0.02%
Average Excess Return	0.03%	Average Excess Return	0.02%

Summary

- a. The excess return earned by Fund T is 7.2% which is higher than excess return earned by Fund S valued at 4.7% during one-year time period. However, the annualised volatility of excess returns earned by Fund T is 7.42% that is approximately equal to the annualised volatility of excess returns earned by Fund S of 7.52%.
- b. As a result of above, Fund T has a higher Information Ratio (0.97) compared to Fund S (0.63). This indicates that Fund T has generated more excess return with nearly same consistency and same level of risk taken as compared to Fund S. Therefore, Fund T has higher Risk Adjusted Return (RAR) as compared to Fund S.

2.2. Illustration 2

Let's assume there are two funds, X and Y under small cap and flexi cap category respectively. The data w.r.t the IR of these 2 funds calculated basis the NAV of these 2 funds and the common benchmark (NIFTY 50) over the last 1-year period are tabulated below:

Fund X		Fund Y	
Excess Return (TD)	4%	Excess Return (TD)	4%
Annualised SD (TE)	8.19%	Annualised SD (TE)	3.36%

Information Ratio (TD/TE)	0.49	Information Ratio (TD/TE)	1.21
Minimum Excess Return	-2.16%	Minimum Excess Return	-0.88%
Maximum Excess Return	1.51%	Maximum Excess Return	0.76%
Median Excess Return	-0.01%	Median Excess Return	0.02%
Average Excess Return	0.02%	Average Excess Return	0.02%

Summary

- The excess return earned by the Fund X and Fund Y is 4% during one- year time period. However, the annualised volatility of excess returns earned by Fund X is 8.19%, which is higher than the annualised volatility of excess returns earned by Fund Y valued at 3.36%.
- As a result of above, Fund Y has a higher Information Ratio (1.21) compared to Fund X (0.49). This indicates that Fund Y has generated same excess return with more consistency and with lesser risk taken as compared to Fund X. Therefore, Fund Y has higher RAR as compared to Fund X.

2.3. Illustration 3

Let's assume there are two funds, W and V under small cap category. The data w.r.t the IR of these 2 funds calculated basis the NAV of these 2 funds and their common tier -1 benchmark over the last 1-year period are tabulated below:

Fund W		Fund V	
Excess Return (TD)	0.5%	Excess Return (TD)	-0.3%
Annualised SD (TE)	3.8%	Annualised SD (TE)	5.05%
Information Ratio (TD/TE)	0.14	Information Ratio (TD/TE)	-0.06
Minimum Excess Return	-0.7%	Minimum Excess Return	-1.12%
Maximum Excess Return	1.18%	Maximum Excess Return	0.94%
Median Excess Return	-0.002%	Median Excess Return	-0.007%
Average Excess Return	0.002%	Average Excess Return	-0.001%

Summary

- The excess return earned by the Fund W is 0.5% and Fund V is -0.3% during one- year time period. However, the annualised volatility of excess returns

earned by Fund V is 5.05%, which is higher than the annualised volatility of excess returns earned by Fund W valued at 3.8%.

- b. As a result of above, Fund W has a higher Information Ratio (0.14) compared to Fund V (-0.06). This indicates that Fund W has generated excess return consistently with lesser level of risk taken as compared to Fund V. Therefore, Fund W has higher RAR as compared to Fund V.

2.4. Illustration 4

Let's assume there are two funds, W and V under small cap category. The data w.r.t the IR of these 2 funds calculated basis the NAV of these 2 funds and their common tier -1 benchmark over the last 5 -year period are tabulated below:

Fund W		Fund V	
Excess Return (TD)	2.9%	Excess Return (TD)	4.5%
Annualised SD (TE)	4.74%	Annualised SD (TE)	10.19%
Information Ratio (TD/TE)	0.62	Information Ratio (TD/TE)	0.45
Minimum Excess Return	-1.20%	Minimum Excess Return	-2.77%
Maximum Excess Return	1.26%	Maximum Excess Return	4.19%
Median Excess Return	0.01%	Median Excess Return	-0.01%
Average Excess Return	0.02%	Average Excess Return	0.03%

Summary

- a. The excess return earned by the Fund W is 2.9% and Fund V is 4.5% during 5- year time period. However, the annualised volatility of excess returns earned by Fund V is 10.19%, which is higher than the annualised volatility of excess returns earned by Fund W valued at 4.74%.
- b. As a result of above, Fund W has a higher Information Ratio (0.62) compared to Fund V (0.45). This indicates that Fund W has generated excess return consistently with lesser level of risk taken as compared to Fund V. Therefore, Fund W has higher RAR as compared to Fund V.

2.5. Illustration 5

Let's assume there are two funds, K and L under Large and Midcap category. The data w.r.t the IR of these 2 funds calculated basis the NAV these 2 funds and their common tier -1 benchmark over the last 1 -year period are tabulated below:

Fund K		Fund L	
Excess Return (TD)	-1.11%	Excess Return (TD)	-1.49%
Annualised SD (TE)	4.08%	Annualised SD (TE)	15.95%
Information Ratio (TD/TE)	-0.27	Information Ratio (TD/TE)	-0.09
Minimum Excess Return	-0.68%	Minimum Excess Return	-8.81%
Maximum Excess Return	1.66%	Maximum Excess Return	8.80%
Median Excess Return	-0.02%	Median Excess Return	-0.03%
Average Excess Return	-0.004%	Average Excess Return	-0.006%

Summary

- a. In this case, both Fund K and Fund L have underperformed their common tier 1 benchmark. The excess return earned by the Fund K is -1.11% while excess return earned by the Fund L i.e. -1.49% during 1- year time period. However, the annualised volatility of excess returns earned by Fund K is 4.08%, which is lower than the annualised volatility of excess returns earned by Fund L valued at 15.95%.
- b. As a result of above, Fund L has a higher Information Ratio -0.09 compared to -0.27 for Fund K. Fund K and Fund L has under-performed their benchmark approximately equally, but the volatility of excess returns of Fund K is lower than that of Fund L. Given the higher variance in excess return of Fund L, the confidence with which it can be said that Fund L will under-perform the benchmark is lower as compared to Fund K. Therefore, Fund L, with a higher IR, has higher RAR w.r.t Fund K.
