Mutual funds demystified

• 4 •

Sunil Subramaniam
Executive Director-Sales & Marketing
Sundaram BNP Paribas Asset Management

To summarize our discussions in the first three parts:

1. Positive Wealth Creation (PWA) is the main goal of the investor.
2. Risk & Inflation are the two main determinants of PWA ie if the returns from the investment process do not adequately compensate for
   a. the level of risk undertaken and/or
   b. the level of inflation suffered, then instead of PWA, Negative Wealth Accretion (NWA) occurs.

We have dealt with the basics of assessing the two factors in parts two and three of this series. Armed with this information, and accessing information that is available in the public domain, a wise investor or alternatively, a wise advisor with some amount of diligent study, can make a reasonably accurate estimation of the prevailing cost of these two factors.

While **this is necessary information,** it is **not sufficient** to make an informed decision.

Why?

That is what we will dwell upon in this article.

Financial Markets are a freely traded domain and information on the various factors that **influence the 'pricing' of risk and 'inflation are freely available (including expert opinions!).** Thus the laws of demand and supply apply and will ensure that the **prevailing market price is fair and reasonable and does not favour either the buyer or seller!!!**

Then what is it that enables one of the two parties to the transaction (ie 'buyer and seller' or 'investor and borrower') to walk away with the BETTER DEAL ??

The answer lies in the

1. **Differentential estimation of the future price trends**

   and

2. **Differential translation of expectation of future price behaviour into actual reality**

Let me explain the same in simpler terms :

The investor is concerned mainly about actual or real risk or inflation incurred. This will be known generally only at the end of the transaction period.

As no one has a crystal ball that accurately predicts the future, every market participant goes about making a calculated or informed guess about the future. It is this **expectation of future price** that is actually traded in the marketplace!!! And deals are concluded on this basis and at this initial stage, each participant feels happy that he has been able to conclude the deal at a price that matches his view of the future. **Both participants feel that they have got a very good deal.** Not only that – each participant feels that the other participant has got an equally bad deal! This is exactly what 'THE GREATER FOOL THEORY' refers to.

Coming now to the second point, **who is the actual winner? the participant whose prediction is closest to the actual reality, as it unfolds in the future,** will be actual winner.

A market participant who is consistently able to match his prediction of future price behaviour with the actual price will be a consistent winner (and can be called a WISE INVESTOR!). There are many such consistent winners (such as Warren Buffet, Bill Gross, George Soros)

What differentiates them from the thousands of market participants ??

i. **Superior knowledge:** access to information about the underlying companies which is not available to others – otherwise known as INFORMATION ASSYMETTRY. This can only be obtained consistently through thorough analysis - an exhaustive study of all the external (global economy, domestic economy, global and domestic industry) and internal (company-specific) factors that can influence a company's future prospects (the examples named are adept at the second way)

ii. **The willingness to act on the knowledge obtained even if the market's consensus view is radically different!!! This is perhaps the most significant from the perspective of making super profits.**

Why?

The answer is quite simple – profits (and especially super profits) are only generated if you are able to buy the asset or commodity at a very cheap price and then proceed to sell the same at a very high price.

When will something be available very cheap ? when everyone feels that the future prospects of revenue from that asset are very low and hence there is nobody willing to buy the same ie there is low demand for the same. When the market perception of the future revenue generating possibility changes for the better, then people rush in to buy the same and hence demand rises and the price also rises!! Hence if your superior information enables you to gauge the higher revenue generation, you can make a killing by buying the asset at bargain prices and then selling the same when the broader market becomes aware of the same!!

The secret mantra is the combination of superior information on the future and the willingness to act on the same. More on this aspect in my next!!