Value Research

Mutual Fund Insight

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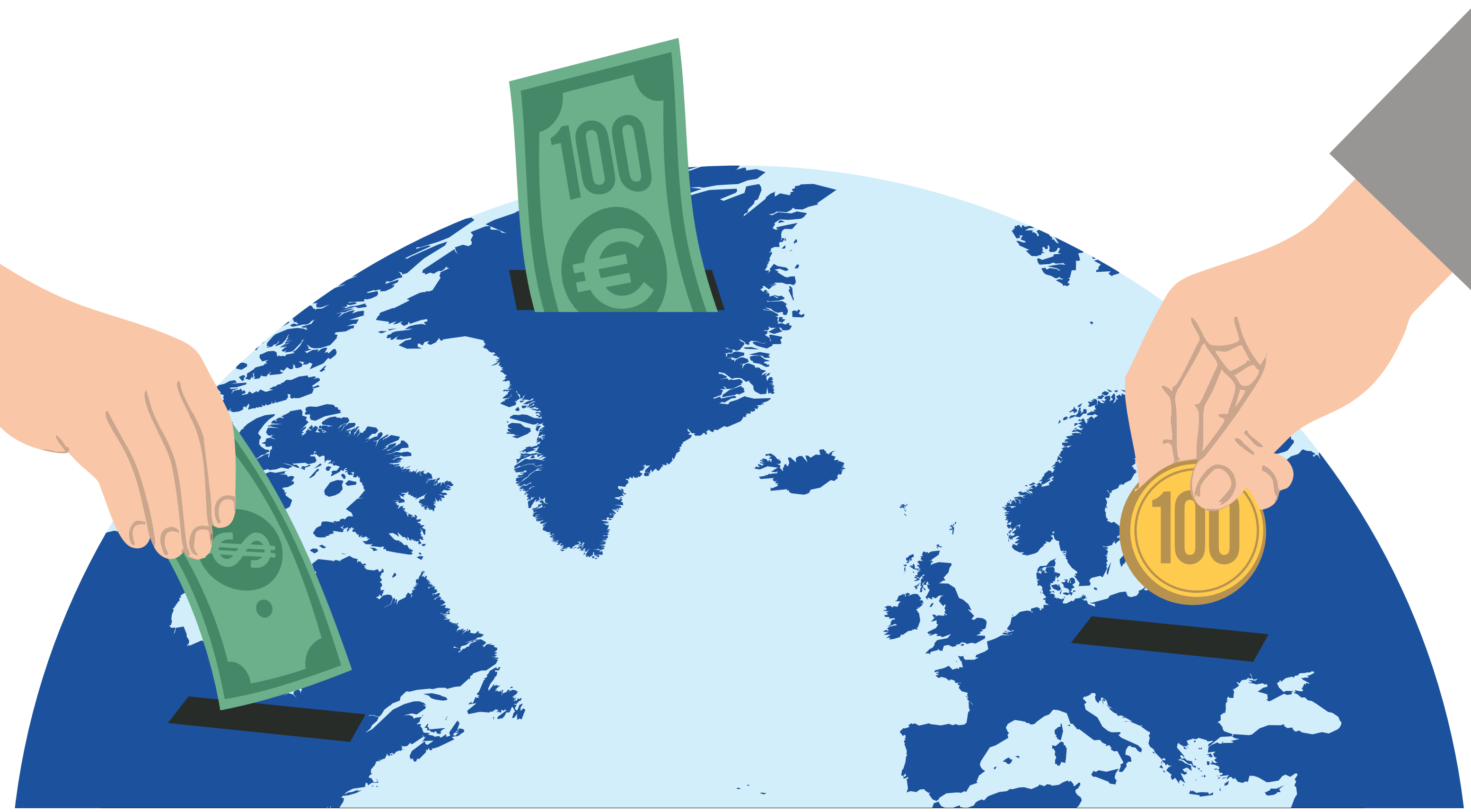

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Less is more if diversified smartly!

How even a few meaningfully selected funds can help you achieve better results

Diversification is investing's most overused cliché and its most misunderstood principle. "Don't put all your eggs in one basket" is repeated so often that it's lost all meaning. Yet the core idea remains sound: markets are unpredictable, and prudent investors must prepare for multiple outcomes.

But how we diversify must evolve. For decades, mutual fund investors have followed a formulaic playbook—spreading capital across large-cap, mid-cap, small-cap, sectoral, and thematic funds. Add some international or passive funds, and you've ticked every conventional box.

Yet portfolios built this way often end up more concentrated than intended—thanks to hidden correlations, overlapping holdings and the false comfort of quantity. Welcome to the era of naive diversification.

Quantity ≠ quality

Investors often confuse more schemes with better diversification. However, holding 12–15 funds with similar benchmark stocks often leads to higher correlation and lower differentiation.

Consider the data. A portfolio of 15 best-performing mutual funds delivered a 10-year median return of 15.4 per cent. But a smaller, sharply constructed portfolio of just five least-correlated schemes delivered 16.7 per cent, highlighting the inefficiency of blind diversification.

The lesson: the illusion of diversity is costly. Smart diversification means selecting truly distinct funds.

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Tools for smarter diversification

Investors serious about avoiding overlap must move from surface-level variety to structural differentiation. This means evaluating schemes through three underappreciated lenses:

Correlation matrices: Understand how funds behave relative to each other during different market cycles.

Portfolio overlap analysis: Identify how two or more schemes share common holdings with one another.

Smart vs naive diversification

The performance gap

Portfolio	10Y annualised return (% pa)	10Y annualised volatility (%)
5 least correlated schemes	16.7	14.5
15 best performing schemes	15.4	15.0

Source: ICRA, NJ Asset Management Pvt. Ltd. Data for the period of 2010 to 2024. Equity schemes from the flexi-cap fund, ELSS, large & midcap, large-cap, mid-cap, small-cap, focused-fund, multi-cap-fund categories are considered.

Same market, different playbook

While most flexi-cap funds crowd into the same stocks, NJ Flexi Cap stands out

Particular	NJ Flexi Cap Fund	Flexi-cap fund category (excluding NJ Flexi Cap Fund)	Top 10 schemes based on performance	Top 10 schemes based on AUM
% overlap vs Nifty 500	16.2	36.0	33.3	36.0
% overlap vs category	9.0	25.8	25.7	25.4

Source: NJ Asset Management internal research, ICRA MFI Explorer. Note: Data as of April 30, 2025. % Overlap against category is calculated as the simple average of % overlap of NJ Flexi Cap Fund, respectively, against each of the live schemes i.e. all open-end and closed-end (if any) in the flexi-cap category, respectively. The top 10 flexi-cap schemes based on performance and AUM have been selected based on one-year point-to-point returns and AUM, respectively, as of April 30, 2025, from within the flexi-cap category. Past data may or may not be sustained in future and should not be used as a basis for comparison with other investments.

Active share: Quantify how much a fund deviates from its benchmark. The higher, the better.

In this framework, smart diversification is not about owning more funds; it's about owning non-redundant ones. And one of the most effective tools for that? Rule-based investing.

The strategy layer: Where smart diversification begins

While traditional diversification focuses on categories—large-cap, flexi-cap, etc., smart diversification adds a second layer: investment strategy.

Rule-based, factor-driven funds shine here. Unlike traditional active funds influenced by manager views and biases, rule-based funds follow set models. They select stocks based on proven factors like value, momentum, quality and low volatility—free of emotions and noise.

This strategy unlocks three critical advantages:

Bias elimination: Removes the human tendency to chase performance, herd into familiar names, or overreact to short-term noise.

Structural differentiation: Rule-based portfolios are often benchmark-agnostic, sector-agnostic and market-cap-agnostic, making them genuinely distinct from traditional funds.

Alpha potential: By diversifying across uncorrelated factors, such funds can outperform benchmarks over the long term, even if they sometimes lag in momentum-driven rallies (think PSU banks or lending-heavy Nifty stocks).

Smart diversification in action

Let's look at what smart diversification looks like in practice.

As of April 2025, most flexi-cap mutual funds, including the top 10 performers and the largest by assets under management (AUM), showed 25-36 per cent portfolio overlap with each other and the Nifty 500. These portfolios may differ in name but not in substance.

In contrast, NJ Flexi Cap Fund stands out with:

- Just 16 per cent overlap with the Nifty 500
- Only about 9 per cent overlap with flexi-cap peers
- An active share exceeding 80 per cent, a strong proxy for genuine differentiation

This is enabled by a 100 per cent rule-based active smart beta strategy focused on quality stocks and zero human bias. For investors tired of duplicating exposure while pretending to diversify, this is true strategic diversification.

True diversification is about thinking differently. In an environment where most funds converge on the same market darlings, standing apart is essential.

Final thought

True diversification isn't about scattering your chips. It's about thinking differently. In an environment where most mutual funds converge on the same market darlings, standing apart is not just wise, it's essential.

Rule-based funds, like those from NJ Mutual Fund, offer investors a way out of the redundancy trap. By focusing on uncorrelated factors, high active share, and process-driven rigour, they enable smart diversification that actually works.

After all, when everyone's building portfolios in a similar fashion, the only real edge is doing it differently and doing it with discipline. ☑

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