

Mutual Fund Insight

April 2026

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NIRMAY CHOKSI

Sherlock Holmes of investing

Unmasking quality traps through forensic and governance analysis

A good investor reads balance sheets. A great investor reads between the lines.

Every checklist has its limits. Earnings look strong, margins are expanding, and the brand is recognised. There are many companies which passed the standard test before failing the only one that ultimately matters: honesty.

The gap between a convincing and an honest financial statement is where Forensic and Governance (F&G) analysis lives. Forensic asks whether the numbers hold together: are reported profits backed by actual cash flow, or dressed up by accounting choices? Governance asks whether the people in charge can be trusted: how do promoters behave, what do related-party transactions reveal, and are disclosures consistent or conveniently vague? Together, they serve one purpose: identifying companies worth avoiding before the market reaches the same conclusion.

Why F&G analysis matters more than most investors think

Think of a detective who rules out the innocent before pursuing the guilty. F&G analysis works the same way: remove the landmines first, then evaluate what remains on its own merits.

Some companies exploit the market's patience for a good narrative. Revenue gets

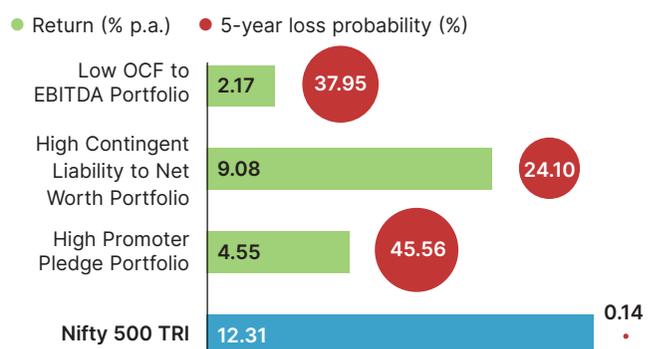
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recognised ahead of collection. Costs get capitalised rather than expensed. One-off gains get folded into recurring income. Working capital gets stretched until profits look healthy and cash quietly vanishes. The tell is almost always there.

Satyam Computers fabricated bank confirmations and inflated cash balances for years. IL&FS Transportation reported capital work-in-progress that never converted into productive assets, while promoter pledges

The cost of ignoring red flags

The real cost is capital, not just returns



Source: NJ AMC's Internal Research, CMIE, NSE, NJ AMC's Proprietary SmartBeta Research Platform. Data is for the period September 30, 2009, to February 28, 2026. The Low OCF to EBITDA Portfolio and the High Contingent Liability to Net Worth Portfolio comprise the bottom 50 stocks from the Nifty 500 universe based on their respective parameters. The High Promoter Pledge Portfolio comprises stocks with more than 25 per cent promoter pledge to their total holdings from the Nifty 500 universe. This data represents a back-tested simulation and does not represent the performance of any existing mutual fund scheme managed by NJ Asset Management Private Limited. Past performance may or may not be sustained and is not indicative of future returns.

Not all quality is created equal

Even inside a quality portfolio, the F&G screen separates the compounders from the pretenders

Portfolio/Model	Sharpe ratio	5-year median rolling returns (% pa)	3-year loss probability (%)
NJ Quality+ Model	0.57	19.72 	1.03 
Top 80 stocks as per F&G ranking	0.62	22.43 	0.28 
Bottom 20 stocks as per F&G ranking	0.38	9.70 	14.81 

Source: NJ AMC's Internal Research, CMIE, NSE, NJ AMC's Proprietary SmartBeta Research Platform. Data is for the period September 30, 2006 to February 28, 2026. Top 80 stocks and Bottom 20 stocks as per F&G ranking represent stocks ranked based on Forensic & Governance (F&G) parameters from NJ Quality+ Model. NJ Quality+ Model is a proprietary methodology developed by NJ Asset Management Private Limited. This data represents a back-tested simulation and does not represent the performance of any existing Mutual Fund scheme managed by NJ Asset Management Private Limited. Past performance may or may not be sustained and is not indicative of future returns.

remained stubbornly high.

Manpasand Beverages saw auditor fees rise sharply across consecutive years. Jet Airways carried contingent liabilities that dwarfed its net worth. In each case, red flags preceded the collapse. The data spoke, but most investors were not looking for it.

Two concepts explain why F&G analysis cuts through: earnings quality and reporting quality. The first checks whether profits are converting into sustainable cash flows. The second asks whether the auditor is independent enough to be believed. Even businesses with impressive performance can fail both tests. High ROE is not a defence against hidden liabilities or compromised disclosures.

Quantifying the red flags

F&G analysis is often mischaracterised as subjective. Red flags can also be quantified and screened systematically. See the chart titled 'The cost of ignoring red flags' on the previous page.

Promoter pledge: When a promoter pledges shares as collateral, the stock becomes leverage in someone else's financial position. A falling price triggers forced selling, which can drive it lower still. A portfolio comprising of companies having high promoter pledges delivered an annualised return of just 4.55 per cent between

September 2009 and February 2026, against the Nifty 500 TRI's 12.31 per cent, with a five-year loss probability of 45.56 per cent.

Operating cash flow (OCF) to EBITDA: Profits can be shaped by accounting choices. Cash flows are harder to manufacture. When operating cash flow falls persistently short of reported EBITDA, the income statement is flattering the business. The Low OCF to EBITDA portfolio returned just 2.17 per cent annually, with a 37.95 per cent chance of loss over five years.

Contingent liabilities to net worth: Off-balance-sheet obligations, pending litigation and unresolved claims can accumulate until they overwhelm a company's financial buffer. High contingent liability portfolios returned 9.08 per cent annually, with a 24.10 per cent five-year loss probability. The Nifty 500 TRI's equivalent figure was just 0.14 per cent. The gap is the cost of ignoring red flags.

Elimination over selection

Sometimes, even high-quality companies can fail the F&G test. F&G analysis is not a replacement for quality; it is the necessary second layer. F&G analysis does not promise outperformance. It promises fewer landmines.

Even from a universe of 100 high-quality stocks (NJ Quality+), the bottom 20 companies as per their F&G ranking trail significantly behind the rest of the stocks with a 14.81 per cent loss probability and returns of just 9.70 per cent per annum. As opposed to this, the remaining top 80 companies carry a three-year loss probability of just 0.28 per cent and a five-year median rolling return of 22.43 per cent per annum.

NJ AMC's quantitative Forensic and Governance model is built on this logic, using quantitative screens to systematically detect red flags across its universe.

While quality gets you into the right neighbourhood, Forensic and Governance make sure you are not buying the house next to a crime scene. 

Mr Nirmay Choksi is the Director and Head of Investment at NJ Asset Management Private Limited and the views expressed above are his own. Please note that neither NJ AMC nor Mr Choksi have a long / short position in the securities mentioned above.

F&G analysis does not promise out-performance. It promises fewer landmines.