Value Research

Mutual Fund Insight

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Complete Personal Finance Guide

The Anti-Panic Playbook

5 Running Strategies to Beat Market Crashes

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Your worst investing enemy? You.

How rule-based investing may help deal with self-inflicting biases

In the world of investing, the biggest threat to long-term wealth isn't just market volatility or economic downturns. It's you.

Behavioural finance, the study of how psychology influences investor decisions, has repeatedly shown that human biases quietly and consistently undermine investment outcomes. Whether you're an amateur or a seasoned professional, your brain is wired to make systematic mistakes. Understanding these biases and designing a portfolio strategy that accounts for them may be one of the most important steps you take as an investor.

The costly pull of human bias

Let's start with **recency bias,** the tendency to overweight recent experiences while discounting long-term patterns. Data shows more than 70 per cent of mutual funds that ranked among the top 20 per cent in one year fail to maintain that position the following year. Meanwhile, nearly two-thirds of bottom performers improve in subsequent years. Thus, chasing last year's stars is often a recipe for disappointment.

Then there's **naive diversification,** spreading investments across too many schemes without examining overlap or correlation. Our analysis shows that a carefully selected portfolio of just five least-correlated schemes outperformed both a random 15-scheme portfolio and even a basket of 15 top performers over 10 years. It's not about how many funds you hold but how thoughtfully they're chosen.

Other traps abound: the **hot hand fallacy,** where investors flock to recently surging sectors, only to be caught off guard when the

From star to struggler: How performance flips year to year

71.3%	66.2%	66.7%	71.3%
Tumbling down: How many top-performing schemes drop off from the top the next year?	**Rising from the depths:** How many bottom-performing schemes escape the bottom the next year?	**The 10-year challenge:** How many recent top performers fall out of the top over 10 years?	**From rock bottom to resilience:** How many recent losers make a comeback over 10 years?

Source: ICRA. Data from January 2000 to November 2024. Schemes from the flexi-cap, ELSS, large & midcap, large-cap, mid-cap, small-cap, focused and multi-cap categories considered. Based on their respective calendar year returns and 10-year CAGR, all the schemes are divided into deciles for each year in the period 2000-2024. 'Top' refers to the schemes in top two deciles and 'Bottom' refers to the schemes in bottom two deciles based on performance.

Smart vs Naive diversification

Portfolio	10Y annualised return (% pa)	10Y annualised volatility (%)	Risk to reward ratio
5 least correlated schemes	16.7	14.5	1.15
15 best-performing schemes	15.4	15.0	1.03
Random 15 schemes	14.5	15.5	0.94

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.

momentum fades; **loss aversion,** which paralyses investors into clinging to poor holdings; or **herd mentality,** seen in the historical manias – from the 17th-century tulip bubble to the 21st-century Bitcoin frenzy – where collective euphoria pushed valuations to absurd heights. Add to this **confirmation bias,** where investors ignore red flags as they align with their optimistic narratives.

Are experienced fund managers prone to behavioural biases?

Many investors assume handing decisions to a skilled, active manager will help sidestep these behavioural traps. But here too, behavioural finance cautions us. Fund managers are humans. They face their own psychological pitfalls: peer comparison bias, short-term career pressures, overconfidence and even self-attribution bias.

Moreover, there's key person risk, the tendency for a scheme's performance to become overly dependent on one individual's decisions. When that individual falters, moves on or is replaced, the portfolio's performance can destabilise. The result? Investors are often paying high active fees without reliably getting high active value.

The case for rule-based, factor-driven investing

This is where factor investing, specifically active smart beta strategies, comes in. By blending the discipline of passive investing with the targeted precision of factor exposures, rule-based smart beta removes the emotional and psychological noise from portfolio management.

Rather than relying on gut calls or market hunches, smart beta strategies follow systematic rules rooted in decades of academic research. They adapt across cycles, applying logic in good times and bad, mitigating biases that trip up investors and managers.

For example, NJ Mutual Fund's 100 per cent rule-based active smart beta approach creates sector-agnostic, benchmark-agnostic and market-cap-agnostic portfolios. The result? Remarkably differentiated portfolios. Data as of March 2025 shows NJ's Flexi Cap Fund has only about 17 per cent overlap with the Nifty 500 Index, and its ELSS Tax Saver Scheme is just about 3 per cent. With active share metrics exceeding 80-95 per cent, these funds stand apart not just from the market but also from peers, offering truly unique exposures.

By combining passive investing with factor exposures, smart beta strategies adapt across market cycles and eliminate biases that plague investors

How investors can take back control

What does this mean for the thoughtful investor? First, it's a call to reject the myth that more schemes equal more diversification. Instead, focus on building a thoughtfully selected portfolio of 4-5 meaningfully distinct funds with minimal overlap.

Second, recognise that the allure of active brilliance is often overhyped. Behavioural biases affect even the best managers and key person dependence adds more layers of risk.

Finally, know that systematic, rule-based strategies like those by NJ Mutual Fund offer a promising way forward. By eliminating human emotion from portfolio construction, they provide bias-free, disciplined and replicable solutions for long-term wealth creation.

In a market where noise is constant and human frailty is inescapable, the smartest move may be to get out of your own way. ☑

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