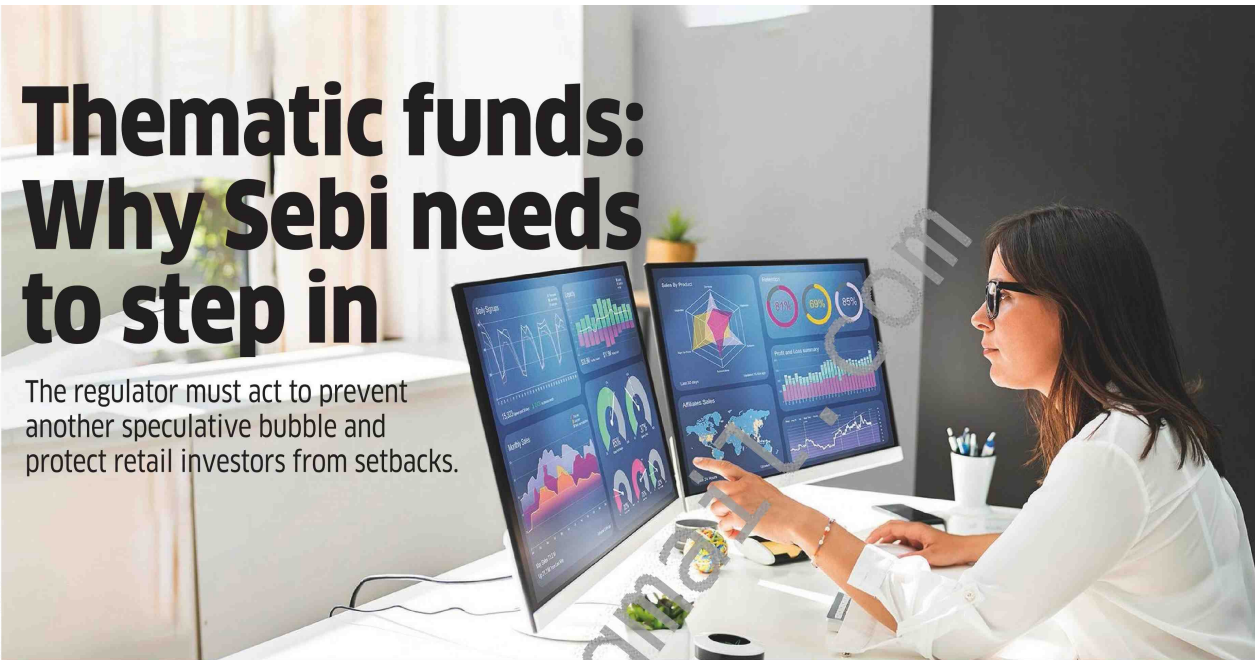


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Thematic funds: Why Sebi needs to step in

The regulator must act to prevent another speculative bubble and protect retail investors from setbacks.

by Sanket Dhanorkar

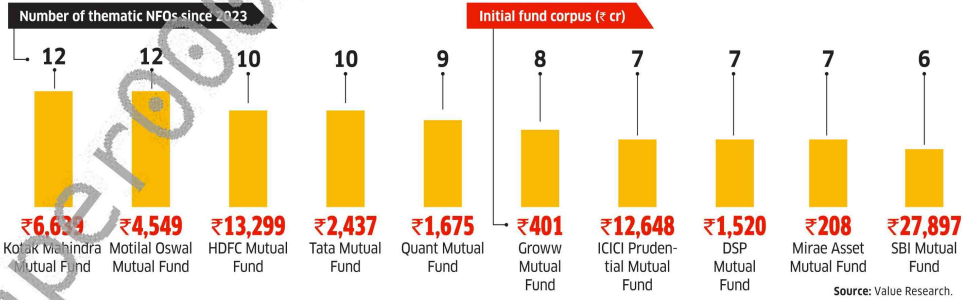
Last year, market watchdog, Sebi, unleashed the broad spectrum of tools at its disposal to quell the exuberance that gripped the futures and options (F&O) market. Alarmed by the slaughter of retail money at the hands of institutional players, Sebi intervened to keep smaller investors from speculating recklessly. However, another binge, playing out concurrently, seems to be flying below the regulator's radar.

Thematic funds sold like hot cakes in 2024 as AMCs hawked differentiated and exotic themes to investors chasing returns. Seduced by compelling narratives woven around fancy new sectors and themes, investors pumped in close to ₹80,000 crore in these new fund offers (NFOs). The party initially kicked off with more diversified offerings, targeting broader investible ideas like business cycles, special opportunities and innovation, among others. With the stock market riding along merrily, AMCs have become more imaginative and investors more adventurous. Newer thematic funds have adopted increasingly focused, narrow ideas. From housing, defence and manufacturing, NFOs have moved on to target themes like tourism, electric vehicles, rural opportunities, conglomerates, among other flavours. Among latest offerings, funds are targeting ideas like railway PSUs and premium consumption.

Paradoxically, the ongoing thematic NFO rush owes its origins to the regulator's own missive to AMCs. In 2018, Sebi had ordered that all schemes be in distinct buckets and invest strictly in accordance with the boundaries defined for each category. Importantly, a fund house could only offer one

Thematic offerings are being sold aggressively

Several AMCs have pushed narrow, exotic themes to investors in recent years.



scheme in each category. This prevented funds from launching different flavours within each category. However, Sebi left the door open for AMCs to offer any number of schemes in the sectoral and thematic baskets. Naturally, asset-hungry AMCs have gravitated towards this space. Product and marketing teams have been working overtime to cook up investing ideas and paint these with a glossy varnish.

However, narratives alone cannot power any investing theme. The earnings growth of underlying companies must support the story. Valuations must allow room for stocks to ride this growth. Unfortunately, many of the thematic offerings launched recently are missing some of these vital ingredients. It is inevitable that many funds will not be able to deliver on their promises. We have seen this story play out in the past. Infrastructure funds launched amid much fanfare in 2006-7 did miserably for many years. Many of the newer thematic funds will suffer the same fate.

Guess what will happen to these thematic offerings after a few years? As performance falters and flows dry up, many are likely to merge with some larger fund. This will

allow AMCs to conveniently mask their chequered track records even as it hurts the existing investors of the bigger fund. Sebi must wake up before this scenario unfolds. The current bandwidth accorded to AMCs to offer themes must be checked.

To be sure, thematic funds can play an important role in the investor's portfolio. These allow you some control over which sector gets to play a meaningful role in your portfolio. When chosen well, a thematic fund can give a kicker to your returns, but timing is a crucial part of playing any sector or theme. Unfortunately, most themes are offered only when there is already a significant tailwind in its favour and is priced in with premium valuations.

Exceptions do exist. A few AMCs are known to launch NFOs only when that theme has not worked well in the past, and so is more likely to do well in the future. Some rarely pursue any thematic NFOs. PPFAS Mutual Fund is one such exception. CIO Rajeev Thakkar's observations on previous narratives, in his latest letter to its unitholders, serve as a warning. "If an investor of today were to time travel back to the 1990s, there would have been excitement around

the opening up of the civil aviation sector to private sector airlines and of the opening up of the telecom sector for private sector cellular operators. We all know that almost all the airlines of that era went bankrupt and, barring one, none of the other telecom companies of that era made any money for their investors," Thakkar notes.

He maintains that the investment outcome for investors in sectoral or thematic funds in the US or India has not been that great because the funds are launched and garner most of the money when the sector is 'hot' and do not get investments when the opportunities are really attractive. Asset Manager Quantum Advisors also observes in its note, "Investors need themes and stories to invest. However, investing in the hype of a theme without being realistic about expectations can lead to bad allocation decisions."

Sebi has done well to curb recent excesses in F&O and SME IPOs. Perhaps it is time to put thematic funds under its spotlight.

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