Sharekhan's top equity fund picks

The market continued its upward march in May 2007. The BSE Sensex and the Nifty advanced by an appreciable 4.8% and 5.1% respectively. Further, the country's leading stock exchange, the Bombay Stock Exchange, achieved an important milestone. The market capitalisation of all the companies listed on the bourse crossed the "one trillion dollar" mark on May 28. The question is: What is filling the market with so much buoyancy even when it is fairly priced at the current levels?

Three things: easing of some concerns, flow of certain positive data and most importantly, strong liquidity. Inflation has been one of the key concerns of the market in recent times, as it has compelled the central bank to tighten its fiscal policy, resulting in higher interest rates and a stronger rupee. Well, the good news is that inflation has finally eased. After spending nearly four months at its high perch of above 6%, the Wholesale Price Index has dramatically climbed down to 4.85% for the week ended May 26. That's the lowest since the week ended July 29 last year and has been achieved in just about a month's time. With the easing of inflation the pressure on interest rates is also expected to ease.

Another source of worry in recent times has been the rupee. The local currency has gained 8% so far in the current year and 14% since August 2006 due to strong foreign fund inflows and the Reserve Bank of India's (RBI) reluctance to support the rupee, as the central bank is concerned that the money supply growth would add to inflationary pressures. But now that inflation has moderated, the probability of the RBI's intervention in the foreign exchange market to support the rupee has increased. In fact, according to media reports, the central bank has already made a beginning by purchasing $500 million from the foreign exchange market on May 28.

That brings us to the factor that is most responsible for the market's steady rise despite having reached its fair value and that is liquidity. Liquidity is in abundance, both locally and globally. Liquidity has swelled globally in the past few years owing to lenient monetary policies of central banks, the emergence of financial instruments like derivatives, and the growth of hedge funds and private equity firms. Investors have been pumping money into India from around the globe in the hope of superior returns. Foreign institutional investors have invested $4.0 billion in Indian equities so far in CY2007 vs $8.8 in CY2006.

No doubt it is India's brilliant performance that is attracting foreign funds by planeloads. The country's economy seems to be on a real high as indicated by the strong economic data released last month. Industrial production grew by 12.9% during March 2007 as against 8.9% in the corresponding period last year. The quick estimates of the Central Statistical Organisation peg the industry growth rate for the entire fiscal at 11.3%. The GDP, the key indicator of the economy's health, grew by a good 9.1% in the March quarter, taking the growth for the full fiscal to a strong 9.4%, higher than the government's estimate of 9.2% and the highest in almost two decades!

Some positive data also flowed from the USA last month, allaying fears that the world's largest economy may be headed for recession. For instance, business activity has rebounded, the jobless rate is almost the lowest in six years and stock markets are on a roll in the world's largest economy. Although inflation at 2% remains in the upper band of the Federal Reserve's (Fed) comfort zone, the Fed chief expects inflation to "moderate gradually over time". The Fed thus appears in no hurry to cut interest rates and the same is reflected in the Fed futures rate chart, which shows a horizontal straight line. The Fed kept the key rate unchanged at its May 9 meeting and its next meeting on June 27-28 is also not expected to yield a rate cut.

However there are some concerns that might spook the market going forward. For one, a host of public offerings-including those of DLF and ICICI Bank-is expected to hit the market in June which is likely to divert a large amount of funds to the primary market. Sample this: DLF and ICICI Bank are together looking to mobilise some Rs25,000-30,000 crore! Besides, the market's valuation at 16.5x forward earnings is close to the level at which it has corrected in the past few instances.

Crude could also pose a threat. Continuing its upward march it touched a high of $70 last month and is expected to hover at these elevated levels in the near term, as it is the peak driving season in the USA and the demand for gasoline would remain high. Also, the hurricane season has begun in the USA and more hurricane storms have been forecast for this year. If crude sustains at such higher levels, the Indian government may be forced to hike the prices of petroleum and petroleum products, which might stoke inflation again.

Most importantly, even though interest rates are expected to peak soon, they have taken their toll on Indian companies in the past few months by slowing down demand and automobiles are expected to be the hardest hit. This coupled with a possible slowdown in export demand and exchange rate impact is likely to take its toll on the earnings of the corporate sector, at least in the first half of FY2008. As earnings growth picks up in the second half, we expect the market sentiment to revive.

We have identified the best equity-oriented schemes available in the market today based on the following parameters: the past performance as indicated by the returns, the Sharpe ratio and Fama (net selectivity).

We have identified the best equity-oriented schemes available in the market today based on the following 3 parameters: the past performance as indicated by the one and two year returns, the Sharpe ratio and Fama (net selectivity).

The past performance is measured by the one and two year returns generated by the scheme. Sharpe indicates risk-adjusted returns, giving the returns earned in excess of the risk-free rate for each unit of the risk taken. The Sharpe ratio is also indicative of the consistency of the returns as it takes into account the volatility in the returns as measured by the standard deviation.

FAMA measures the returns generated through selectivity, ie the returns generated because of the fund manager's ability to pick the right stocks. A higher value of net selectivity is always preferred as it reflects the stock picking ability of the fund manager.

We have selected the top 10 schemes upon ranking on each of the above 4 parameters and then calculated the mean value of each of the 4 parameters for the top 10 schemes. Thereafter, we have calculated the percentage underperformance or over performance of each scheme (relative performance) in each of the 4 parameters vis a vis their respective mean values.

For our final selection of schemes, we have generated a total score for each scheme giving 30% weightage each to the relative performance as indicated by the one and two year returns, 30% weightage to the relative performance as indicated by the Sharpe ratio and the remaining 10% to the relative performance as indicated by the FAMA of the scheme.

All the returns stated below, for less than one year are absolute and for more than one year the returns are annualised.

We present our recommendations in the equity-oriented mutual fund category.

Aggressive Funds

Mid-cap Category

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
Reliance Growth	294.38	12.91	33.48	49.08
Birla Mid Cap	71.82	16.74	34.82	44.58
ICICI Prudential Emerging STAR	30.71	11.88	31.80	50.99
SBI Magnum Midcap	23.63	10.42	30.41	48.54
Kotak Midcap	22.04	14.15	24.15	41.40
Indices				
BSE Midcap		12.96	23.16	38.09

Opportunities category

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
ICICI Prudential Dynamic Plan	69.97	11.24	38.75	56.19
ABN AMRO Opportunities	23.81	21.01	45.15	52.67
Fidelity Equity	23.48	16.16	44.28	51.12
HSBC India Opportunities	30.50	14.77	35.18	50.55
Franklin India Opportunity	27.83	16.37	40.60	51.52
DSP ML Opportunities	59.28	13.65	34.36	48.50
Reliance Equity Opportunities	22.74	11.06	33.81	48.91
Franklin India Flexi Cap	22.25	13.38	31.56	48.12
Indices				
BSE Sensex	14544.46	12.42	39.87	47.17

Equity diversified/conservative funds

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
Birla SunLife Frontline Equity	55.67	16.54	49.33	49.98
DSP ML Top 100 Equity	63.88	17.09	45.36	52.28
HDFC Equity	161.28	14.20	39.96	50.16
Franklin India Prima Plus	151.53	14.26	47.47	51.12
ICICI Prudential Power	89.20	14.86	37.51	52.51
HDFC Top 200	119.10	15.33	36.37	47.24
Sundaram BNP Paribas Select Focus	63.20	11.45	32.64	51.02
SBI Magnum Multiplier Plus 93	56.39	11.42	32.25	54.45
ICICI Prudential Growth Plan	99.80	13.89	33.74	47.62
Birla SunLife Equity	202.36	18.65	46.53	49.64
Indices				
BSE Sensex	14544.46	12.42	39.87	47.17

Thematic/Emerging trend funds

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
DSP ML India Tiger	36.68	16.67	45.00	58.95
SBI Magnum Sector Umbrella - Contra	41.43	16.08	35.44	55.38
Tata Infrastructure	25.74	16.68	34.84	51.44
Tata Equity P/E	29.68	23.82	41.71	42.61
Templeton India Growth	73.63	18.18	35.92	41.20
Indices				
BSE Sensex	14544.46	12.42	39.87	47.17

Balanced funds

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
HDFC Prudence	120.89	8.43	33.88	37.27
DSP ML Balanced	42.51	14.87	33.04	36.93
Birla SunLife 95	199.50	15.12	32.73	36.46
FT India Balanced	35.23	10.55	31.47	34.21
Tata Balanced	54.42	13.06	29.05	33.29
Indices				
Crisil Balanced Fund Index	2577.86	9.95	25.29	26.96

Tax planning funds

Scheme Name	NAV	Returns as on May 31, 07(%)		
		3 Months	1 Year	2 Years
PRINCIPAL Tax Savings	86.09	16.28	37.32	50.45
SBI Magnum Tax Gain Scheme 93	46.57	8.60	37.81	48.25
Birla SunLife Tax Relief 96	101.92	16.77	38.27	47.47
HDFC Taxsaver	153.77	13.79	27.00	42.35
Indices				
BSE Sensex	14544.46	12.42	39.87	47.17

Risk-return analysis

The charts on the following pages give you a snapshot of how the mutual funds have performed on the risk-return parameters in the past. We have used the bubble analysis method to measure their performances on three parameters viz risk, return and fund size. The risk is measured by standard deviation, which measures the average deviation of the returns generated by a scheme from its mean returns. We have tried to explain the same with the help of a diagram, which is divided into four quadrants, with each quadrant containing funds of a particular risk-return profile. The size of the bubble indicates the size of the fund.

The funds in the **high-risk high returns** quadrant follow a very aggressive approach and deliver high absolute returns compared to its peers albeit at a higher risk.

The funds in the **low-risk high returns** quadrant outperform the peer group on the risk-adjusted returns basis as they deliver higher returns compared to its peers without exposing the portfolio to very high risk.

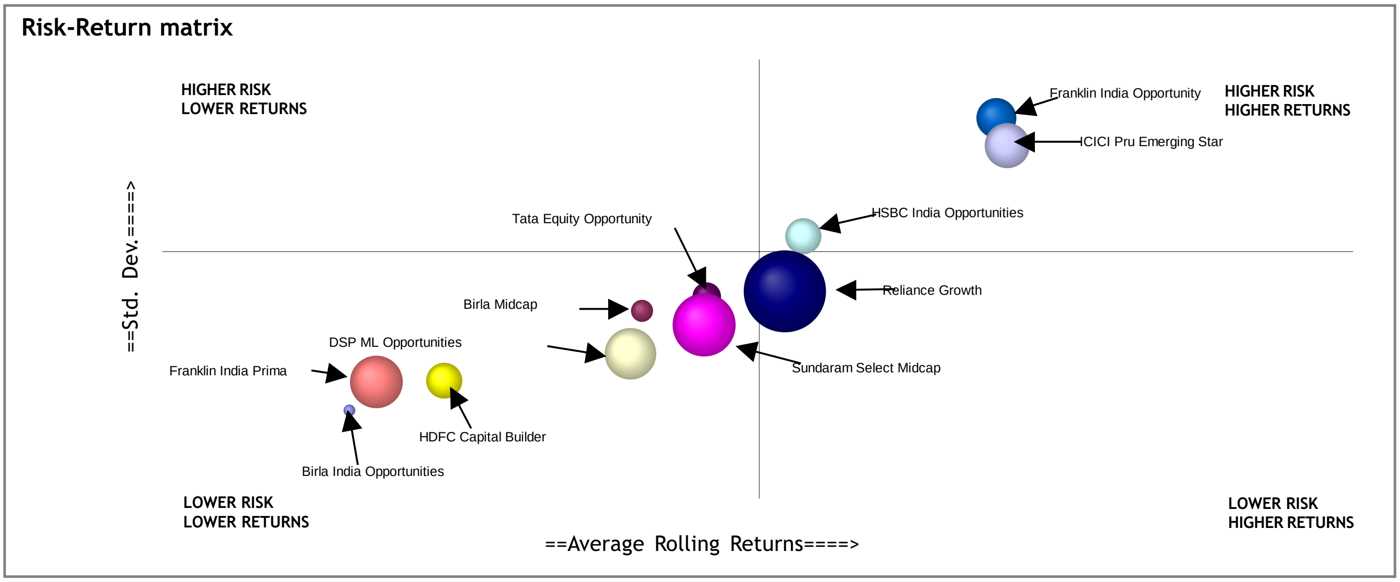
The funds in the **low-risk low returns** quadrant are not very aggressive and provide lower absolute returns, taking lower risks.

The funds in the **high-risk low returns** quadrant underperform the peers on the risk adjusted returns basis as they adopt a high-risk strategy but the returns fail to compensate the risk taken by the fund.

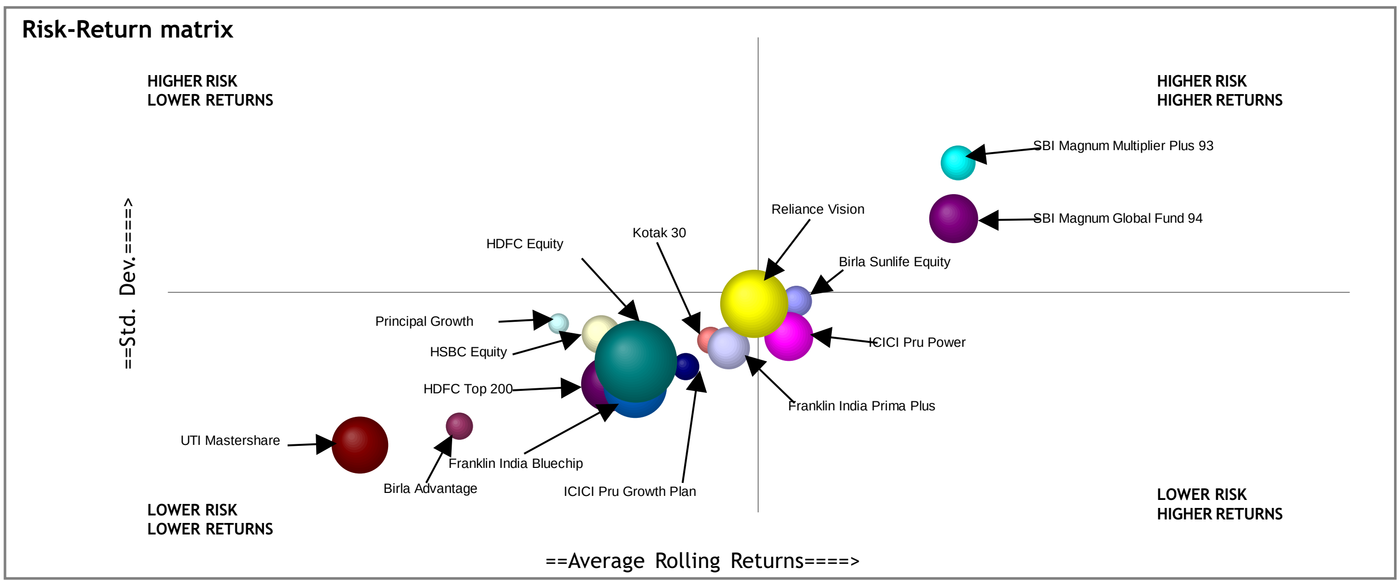
For aggressive, conservative and tax planning funds, risk is measured in terms of two years' volatility while returns are measured as two years' average rolling returns as on May 31, 2007. For thematic and balanced funds, risk is measured in terms of one year's volatility while returns are measured as one year's average rolling returns as on May 31, 2007.

Every individual has a different investment requirement, which depends on his financial goals and risk-taking capacities. We at Sharekhan first understand the individual's investment objectives and risk-taking capacity, and then recommend a suitable portfolio. So, we suggest that you get in touch with our Mutual Fund Advisor before investing in the best funds.

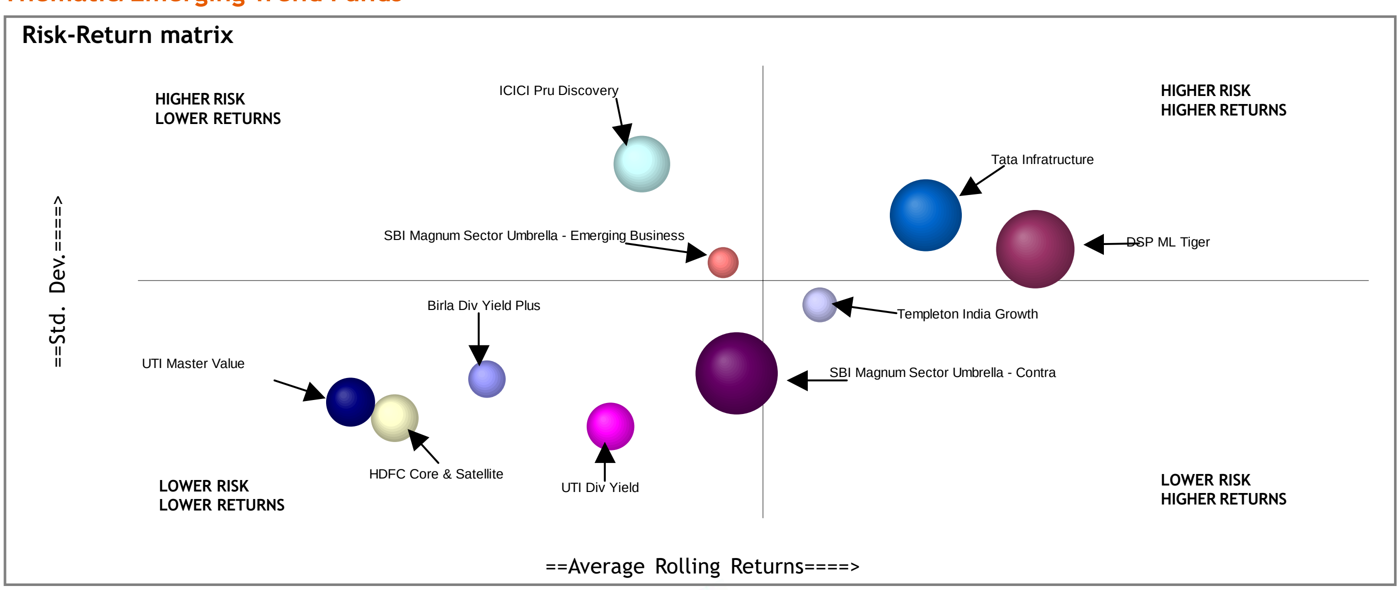
Aggressive Funds



Equity Diversified/Conservative Funds

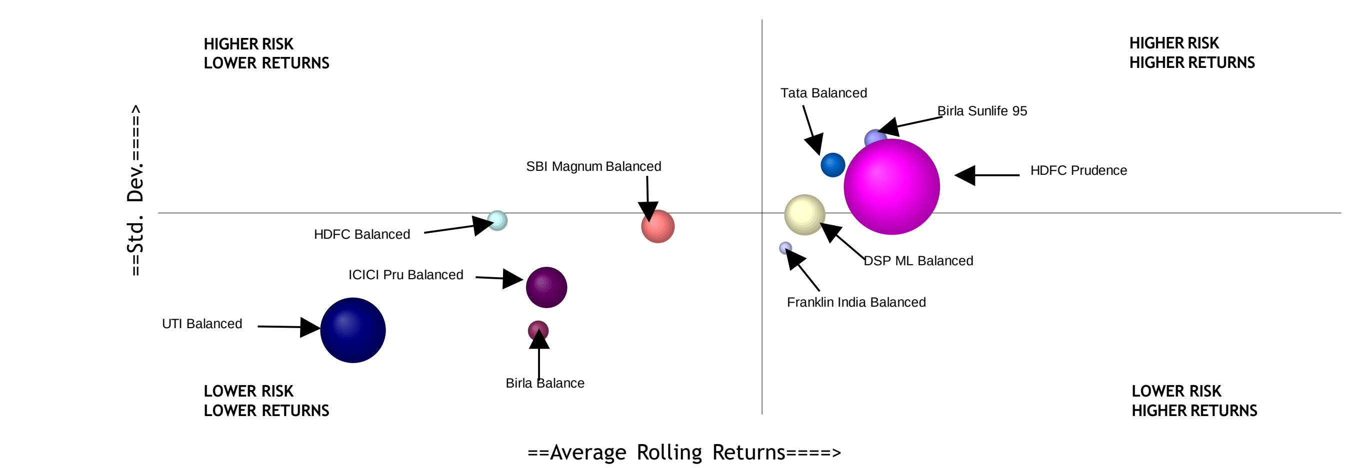


Thematic/Emerging Trend Funds



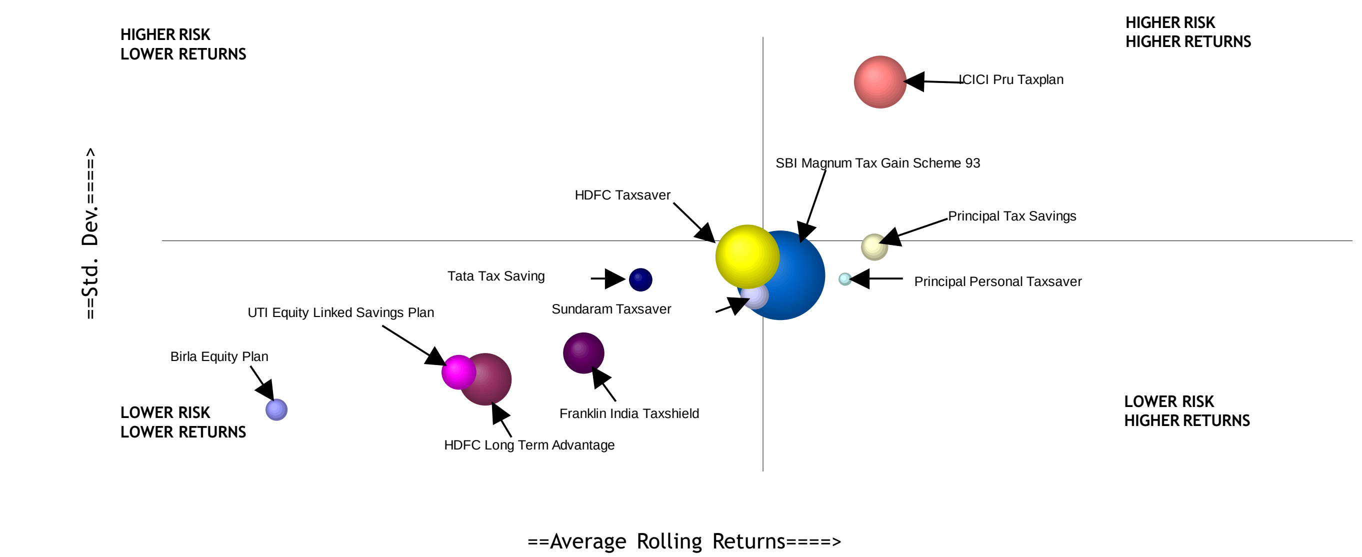
Balanced Funds

Risk-Return matrix



Tax Planning Funds

Risk-Return matrix



Disclaimer: mutual fund investments are subject to market risk. Please read the offer document carefully before investing. Past performance may or may not be sustained in the future.