Nippon India Mutual Fund
Wealth sets you free

THE NIPPON WAY

Good gets better

Investment Process – the Nippon Way

In the previous editions of the Nippon Way, we explained to you the importance of having Sector Limits, Active Share thresholds and Style Diversification in portfolio construction to possibly achieve relatively consistent returns. In this edition, we are highlighting the process of assigning Risk Rating to stocks and using that to mitigate portfolio risks.

Part 4: Investment Process

Risk Rating of Securities

While potential of generating returns is an important dimension while considering a stock to be part of a portfolio, equally, if not more important, would be the risks associated with the stock. Risk is generally measured using post-facto quantitative parameters like the volatility of the stock (usually standard deviation of returns), Beta (relative volatility when compared to benchmark), Value at Risk (VaR), etc. These are useful measures that are based on the past performance of the stock. However, they may not completely capture the inherent risks, which may transpire in the future.

At Nippon India Mutual Fund, in addition to being aware of ex-post (past) risks through quantitative numbers, we also qualitatively assess ex-ante (future / potential) risks.
The Research Team internally rates all the stocks under our coverage on a Scale of A to D, by considering Business Risks and Management Quality. For Business Risk, amongst other parameters, normalized RoE (Return on Equity), stability of Earnings, Terminal Growth Rate, etc are assessed. Similarly, for Management Risk, various aspects such as the Corporate Governance framework followed by the company, Related Party transactions, treatment of subsidiary companies, Disclosure Policy, etc are evaluated to assign Rating.

Stocks rated A (low risk) would mean that the underlying business is robust, and the quality of company management is superior. Companies based on our assessment, which are relatively high on risks, by considering both Business and Management Quality, will be assigned a lower rating. The Fund Casing framework that has been defined for funds would not permit investing into such stocks, beyond a very small limit, to mitigate portfolio risk.

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At Nippon India Mutual Fund, we are conscious of portfolio risks, and endeavor to mitigate them. By placing limits at the portfolio construction stage based on Risk Rating and continuous monitoring through our Investment Committee and PDCA (acronym for Plan, Do, Check and Act – a formal review mechanism to evaluate the portfolios in detail) meetings, we keep the Risks at check.

Endeavor to generate returns within a risk-mitigated framework, the Nippon Way!