



# Deep Dive

30 September 2025

## The 1 Year Return Trap

Stop focusing on short-term wins! This analysis, spanning mutual fund data from 2005 to 2025, shows that a fund's recent stellar performance especially its 1-year return is often a misleading boost that inflates its overall record and doesn't reliably predict future success. The main lesson is to resist the urge to "chase" the current top-ranked funds; true investing strength comes from consistency over the long haul, not from a single, spectacular sprint.

## The 1 Year Return Trap

Imagine you're an investor, and an equity asset manager approaches you, showcasing a set of brilliant returns. They're in the middle of a "purple patch", a period of excellent, recent outperformance—and they're eager to show off. They present periodic returns (1-year, 3-year, 5-year) stacked against the market benchmark and their competitors.

You look at the numbers, and they all look impressive. This happens because the manager's incredible recent outperformance (the 1-yr return) simply folds into and inflates the 2-yr, 3-yr, and 5-yr performance as well.

Also, often the time proven schemes go through temporary rough patch. In such situations, the fund manager could be under pressure to change selection thesis.

In this study, we evaluate the efficacy of looking at only the recent outperformance.

### One year return folds into other period returns

As indicated above, the funds who hit a purple patch (recent outperformance – 1 year return in this case) approach investors and showcase them periodic returns as against the benchmark / peer group.

Illustration listed below demonstrates that recent outperformance (1 year in this case) folds into 2 yr, 3 yr, 4 yr, 5yr returns as well.

If one looks at point to point returns as of Aug-25, it shows as:

Point to Point CAGR Returns as on 31-Aug-2025					
	1 Yr	2 Yr	3 Yr	4 Yr	5 Yr
Fund 1	15.0%	15.0%	15.0%	15.0%	15.0%
Fund 2	45.0%	19.8%	17.1%	16.4%	15.1%

Fund 2 looks better than Fund 1 across time horizons.

Now, Consider the performance of the following 2 funds in each of the last 5 years

Last 5 Year Returns (As on 31-Aug-2025)					
	2025	2024	2023	2022	2021
Fund 1	15.0%	15.0%	15.0%	15.0%	15.0%
Fund 2	45.0%	-1.0%	12.0%	14.0%	10.0%

As we deep dive, we can see that Fund 1 has been a consistent fund across the 5 calendar years. Whereas, Fund 2 has done exceptionally well in 2025 (could be that a couple of stocks gave exceptional returns in 2025).

Though, Fund 2 looks better than Fund 1 across time horizons. However, we know that fund 1 has been more consistent.

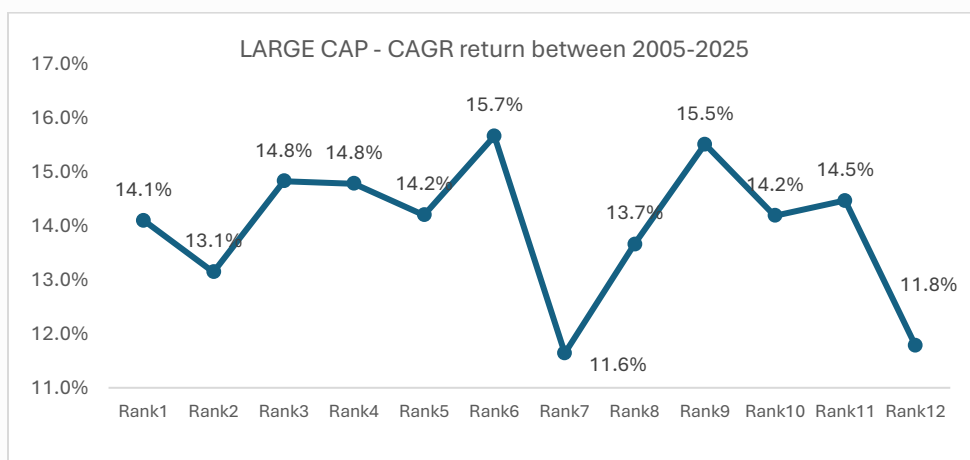
- Should we only look at recent outperformers amongst a peer group?
- Should we sulk unduly if our trusted manager lagged peers in the last 1 year?

In an attempt to answer these questions, we did the following analysis on mutual fund schemes. We have picked MFs because of the depth of available data. The thesis should be equally true for all other asset managers.

## Test (1) – Investing for next 1 year basis last 1 year's ranking

- We ranked 32 large-cap mutual funds each year based on their 1-year performance, starting from 2005.
- For the next 20 calendar years (2005–2025), we invested annually in the fund that was ranked #1 in the previous year.
- To summarize, we redeemed the investment at the end of each calendar year and reinvested the proceeds into the top-ranked fund based on the prior 12-month return.

*We got the following CAGR returns at the end of the testing period (2005-2025):*

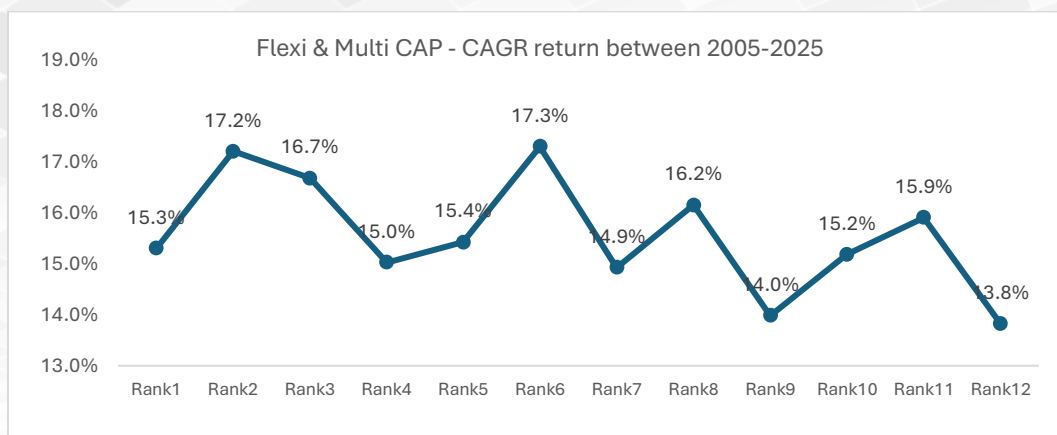


*In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 12 means investing every year into #12 ranked fund*

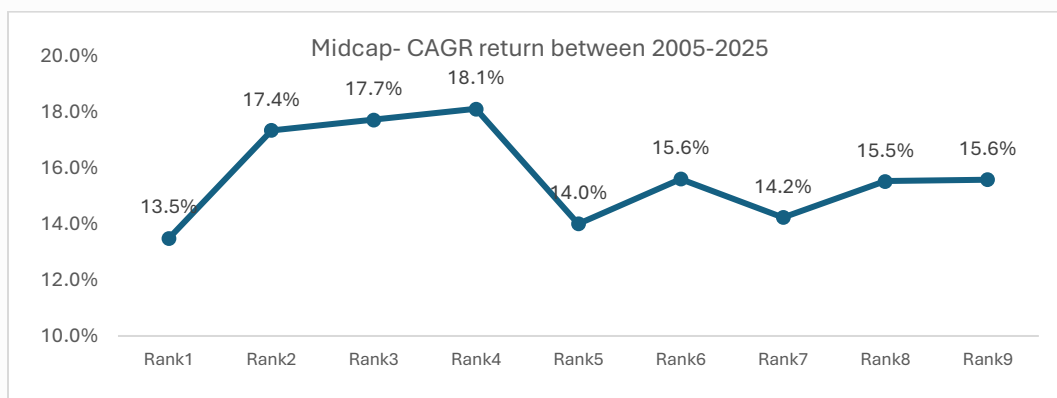
## Findings: - Test (1)

- Selecting the #1 ranked fund each year resulted in a CAGR of 14%. Interestingly, consistently choosing the #6 ranked fund each year delivered a higher CAGR of 16%.
- It is a random dispersion. Next year's performance has no relation with last year's performance.

We extended the same analysis to Multi/Flexi-cap mutual funds (30 funds) and Midcap mutual funds (29 funds) for the period from 2005 to 2025. The CAGR return, at the end of the period are shown below:



In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 12 means investing every year into #12 ranked fund



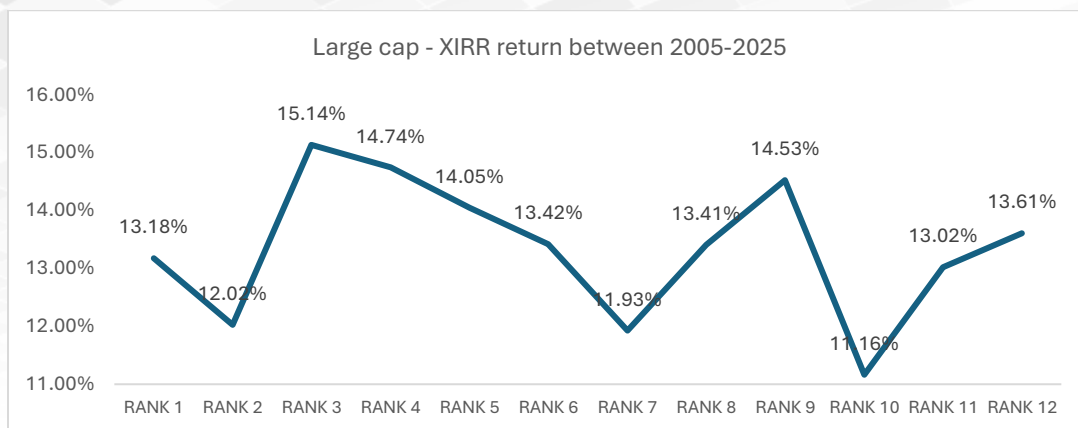
In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 12 means investing every year into #12 ranked fund

As can be seen in the chart above, a similar trend of random dispersion is evident in Flexi/Multi Cap and Midcap strategies.

## Test (2) – Investing for longer horizons! Investing for next 3 years basis last 1 year's ranking

- Acknowledging that a 1-year investment horizon may be too short to assess outperformance, we extended the analysis to evaluate 3-year returns of the selected funds.
- Each year, ₹100 was invested into the fund that ranked #1 based on the previous year's 1-year performance, and this investment was held for next 3-year period.
- We get a set of cash flows wherein Rs. 100 is invested every year into #1 ranked fund of last year and each year some money is maturing (which was invested 3 years before).
- To simplify, we are comparing 3-year performances of the funds based on last 1 year ranking.

*We got the following XIRR returns at the end of the testing period (2005-2025):*

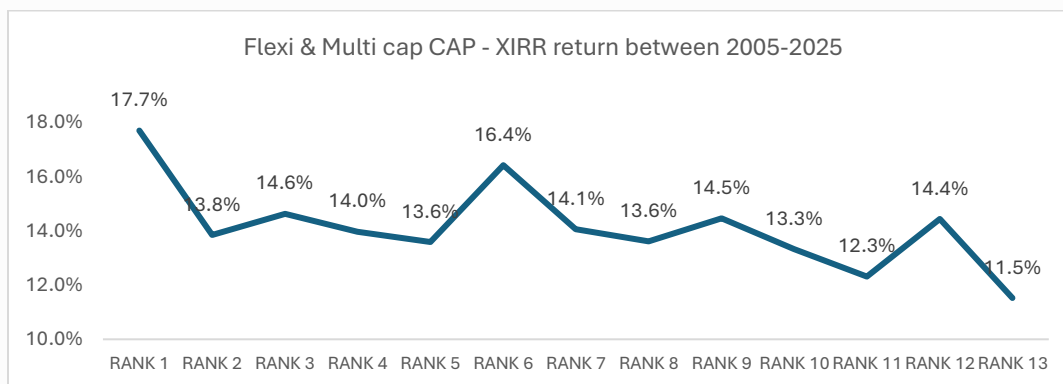


*In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 8 means investing every year into #8 ranked fund*

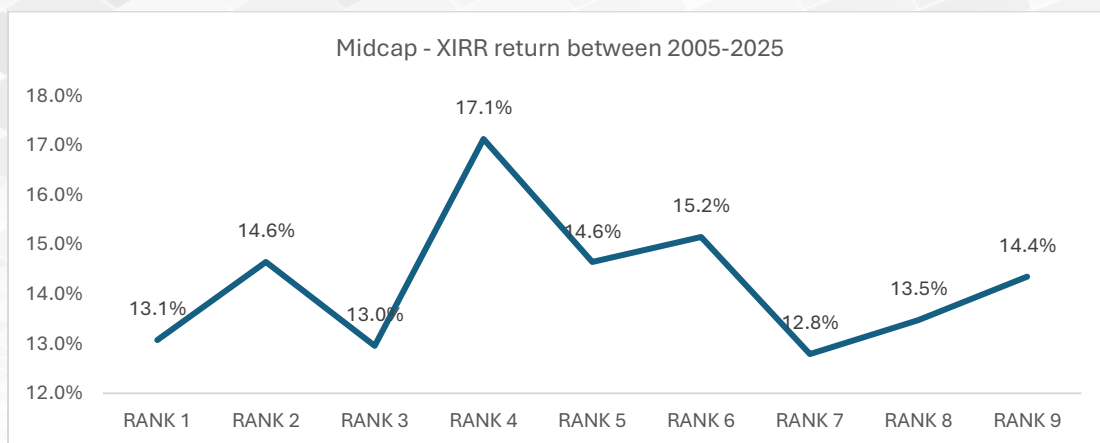
### Findings – Test (2):

- Choosing #1 ranked fund each year gives a XIRR of 13%. Whereas, if one had invested in #3 ranked fund, it would have generated higher returns of 15% XIRR!
- It is a random dispersion. Long term performance has no relation with last year's performance.

We extended the same methodology to Multi/Flexi-cap mutual funds (30 funds) and Midcap mutual funds (29 funds) over the period from 2005 to 2025. Key observations are highlighted in the chart below: -



*In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 8 means investing every year into #8 ranked fund*



*In the chart x axis – Rank 1 means investing every year into #1 ranked funds, Rank 2 means investing into #2 ranked fund ....and so on. Rank 8 means investing every year into #8 ranked fund*

We're seeing similar results in Midcap and Flexi/Multi Cap strategies, where return dispersion is quite evident.

A unique trend in the Flexi/Multi Cap category shows that while the Rank 1 fund has delivered the best performance, there's a lack of consistency among the other ranked funds. Notably, the Rank 6 fund emerges as the second-best performer, clearly highlighting the disparity in returns across the ranking spectrum.

### Conclusions:

- Recent outperformance folds into periodic returns (2yr, 3 yr, 5yr).
- Higher periodic returns do not imply consistency in fund's performance.
- Selecting funds on basis of recent outperformance does not ensure future outperformance.



## Disclaimer

This communication is being sent by the Investment Advisory Group of HSL IA., registered under SEBI (Investment Advisors) Regulations, 2013 under the Registration number INA000011538.

This note has been prepared exclusively for the benefit and internal use of the recipient and does not carry any right of reproduction or disclosure. Neither this note nor any of its contents may be used for any other purpose without the prior written consent of HSL IA, Investment Advisory Group (HSL IA). In preparing this note, we have relied upon and assumed, without any independent verification, accuracy and completeness of all information available in public domain or from sources considered reliable. This note contains certain assumptions and views, which HSL IA considers reasonable at this point in time, and which are subject to change. Computations adopted in this note are indicative and are based on current market prices and general market sentiment. No representation or warranty is given by HSL IA as to the achievement or reasonableness or completeness of any idea and/or assumptions. This note does not purport to contain all the information that the recipient may require. Recipients should not construe any of the contents herein as advice relating to business, financial, legal, taxation, or other matters and they are advised to consult their own business, financial, legal, taxation and other experts / advisors concerning the company regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this note and should understand that statements regarding future prospects may not be realized. It may be noted that investments in equity and equity-related securities involve a degree of risk and investors should not invest any funds unless they can afford to take the risk of losing their investment. Investors are advised to undertake necessary due diligence before making an investment decision. For making an investment decision, investors must rely on their own examination of the Company including the risks involved. Investors should note that income from investment in such securities, if any, may fluctuate and that each security's price or value may rise or fall. Accordingly, investors may receive back less than originally invested. Neither HSL IA nor any of its employees shall be liable for any direct, indirect, special, incidental, consequential, punitive or exemplary damages, including lost profits arising in any way from the information contained in this material. This note does not constitute an offer for sale, or an invitation to subscribe for, or purchase equity shares or other assets or securities of the company and the information contained herein shall not form the basis of any contract. It is also not meant to be or to constitute any offer for any transaction. HSL IA and its affiliates, officers, directors, key managerial persons and employees, including persons involved in the preparation or issuance of this material may from time to time, have long or short positions in, and buy or sell the securities thereof, of company (ies) mentioned herein. HSL IA may at any time solicit or provide commercial banking, credit, advisory or other services to the issuer of any security referred to herein. Accordingly, information may be available to HSL IA, which is not reflected in this material, and HSL IA may have acted upon or used the information prior to, or immediately following its publication.

HSL IA neither guarantees nor makes any representations or warranties, express or implied, with respect to the fairness, correctness, accuracy, adequacy, reasonableness, viability for any particular purpose or completeness of the information and opinions. Further, HSL IA disclaims all liability in relation to use of data or information used in this report which is sourced from third parties.

Please note that HDFC Securities has a proprietary trading desk. This desk maintains an arm's length distance with the HSL IA team and all its activities are segregated from HSL IA activities. The proprietary desk operates independently, potentially leading to investment decisions that may deviate from research views.

HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Murlu V Karkera Email: [complianceofficer@hdfcsec.com](mailto:complianceofficer@hdfcsec.com) Phone: (022) 3045 3600

For grievance redressal contact Customer Care Team Email: [customer care@hdfcsec.com](mailto:customer care@hdfcsec.com) Phone: (022) 3901 9400

HDFC Securities Limited, SEBI Reg. No.: NSE, BSE, MSEI, MCX: INZ000186937; AMFI Reg. No. ARN: 13549; PFRDA Reg. No. POP: 11092018; IRDA Corporate Agent License No.: CA0062; SEBI Research Analyst Reg. No.: INH000002475; SEBI Investment Adviser Reg. No.: INA000011538; CIN - U67120MH2000PLC152193

Investment in securities market are subject to market risks. Read all the related documents carefully before investing.

Mutual Funds Investments are subject to market risk. Please read the offer and scheme related documents carefully before investing.

Registration granted by SEBI, membership of BASL (in case of IAs) and certification from NISM in no way guarantee performance of the intermediary or provide any assurance of returns to investors.

This information is for educational/information purposes only.