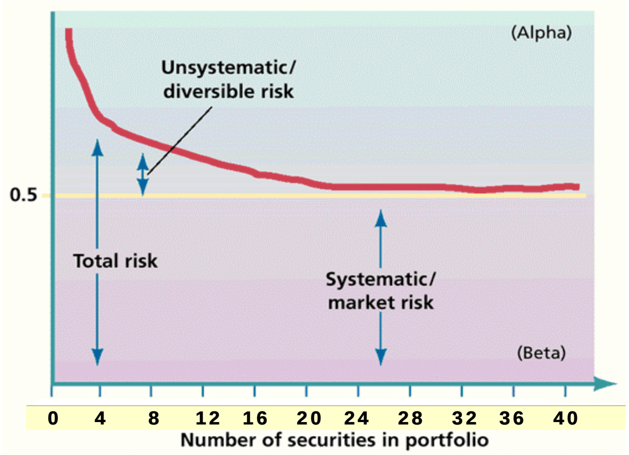
March 15, 2008

ICICI Prudential Focused Equity Fund

An Open ended Equity Scheme

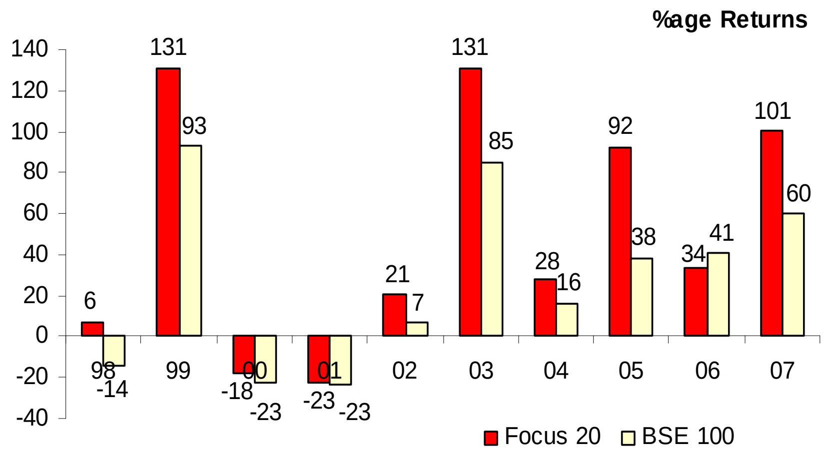
Concentrate all your thoughts upon the work at hand. The sun's rays do not burn until brought to a focus.
- Alexander Graham Bell - An eminent scientist, inventor and innovator

The need for Focus



To the core of sound investing lies the need for balancing risk and return. The most scientific and commonly used approach to balance risk and return is diversification. The higher the diversification, the lower the risk and moderate the return, and vice a versa. However beyond a point, diversification does not help reduce the risk effectively while continuing to hurt the returns. According to Edwin J. Elton and Martin J. Gruber's book "Modern Portfolio Theory and Investment Analysis", the point of balance is at 20, i.e., a portfolio of stocks focused on 20 stocks is optimal in reducing risk while retaining return potential of a portfolio.

To illustrate whether such Focus works in practical market conditions, more so in Indian market conditions, we constructed a portfolio of 20 (randomly selected) stocks from the list of stocks in the BSE 100 Index. We sorted all the constituent stocks for 10 calendar years till 2007. Out of 100 index stocks, based on the yearly performance of each stock, we created 10 buckets of 10 stocks each. To build a portfolio of 20 stocks, now we picked up the best and the worst performing stock from each bucket. We observed that the returns from this focused portfolio out-performed the BSE 100 for 9 out of the 10 years under consideration, with an average out-performance of 22.37% p.a.
(Data Source: BSE website, Capitaline)



This was the outcome, when the portfolio was not actively managed and randomly distributed. When the portfolio is actively managed based on research and proven stock selection capability, the return potential could be much higher.

Introduction to ICICI Prudential Focused Equity Fund

ICICI Prudential Focused Equity Fund is an open-ended equity scheme that aims to maximize long-term capital appreciation by investing in equity and equity related securities of about 20 companies. The Scheme seeks to capture the best opportunities that the market presents, without any sector bias. The fund shall look at such opportunities in the universe of large and established companies.

Concentration:
We all know that, putting all your eggs in one basket increases the risk of losing all or most of the eggs and hence one needs to diversify. While that is true, one also cannot allocate one basket to one egg and needs to hold the optimal number of eggs in each basket. This holds good for investments in equities as well. While diversification is needed to reduce risk, one could end up losing the potential higher returns if there is over-diversification. As we keep adding additional securities the risk keeps on reducing. However, after a certain point, adding more stocks to the portfolio does not reduce risk to a great extent but may end up diminishing the returns. In Edwin J. Elton and Martin J. Gruber’s book “Modern Portfolio Theory and Investment Analysis”, they conclude that you'd come very close to achieving optimal diversity after adding about the 20th stock.
The following are the key benefits that are intended to be derived from portfolio concentration:

- Potential to generate Alpha from being over weight on certain high conviction picks.
- The portfolio could take exposure to any particular theme and has the flexibility to choose between stocks across themes / sectors / investment styles.
- The fund believes that risk of higher concentration can be more than offset / compensated by higher returns.

Large Cap Orientation:
The Fund will look at investing in companies in the large cap space. Large caps have an inherent attribute of resilience to short-term turbulence in the markets. These are less volatile as compare to small and mid cap stocks. Large caps also show the general direction of the economy in a much broader sense. Large caps make perfect sense for a focused portfolio, as the fund takes large exposure to certain stocks and liquidity is very important to avoid a high impact cost at the time of buying or selling. Large caps are generally characterized by the following:

- Reflects broad economic direction
- Higher Liquidity due to (typically) broader investor and higher institutional participation
- Relatively lower volatility compared to their smaller counterpart
- Since large companies are well researched, they are less prone to misinformation shock
- Large caps are more resilient as they recover faster than small and mid cap stocks

Bottom-up stock picking:
The fund will follow the bottom-up approach to identify stocks available at bargain price. This will involve intensive company visits and research to arrive at an intrinsic value of the company and identifying and investing in stocks with promising potential for long-term growth.

Investment Strategy

The fund, while following the broad investment strategy as per the offer document, would follow the below mentioned internal investment guidelines:
Stock Universe: The funds portfolio will comprise of Top 200 companies in terms of Market Capitalization from the companies listed on the National Stock Exchange of India Ltd. (NSE).
Stock Allocation: Subject to liquidity, market volatility and the size of the portfolio, the Fund reserves the right to increase the number of companies to more than 20. Nearly 80% of the portfolio of the scheme is intended to be invested into a maximum of 20 stocks belonging to the large cap domain.
Sector Allocation: Bottom up stock picking. Sectoral allocation will be dynamic and could be concentrated based on market theme or momentum.

Scheme Features

Type	Open ended Equity Scheme
Investment Pattern	Equity & equity related securities – 70% to 100%, Debt & Money Market Instruments (including cash equivalent) – 0 to 30%
Investment Objective	Seeks to generate long-term capital appreciation and income distribution to unitholders from a portfolio that is invested in equity and equity related securities of about 20 companies belonging to the large cap domain and the balance in debt securities and money market instruments. The Fund Manager will always select stocks for investment from among Top 200 stocks in terms of market capitalization on the National Stock Exchange of India Ltd. If the total assets under management under this scheme goes above Rs.1000 crores the Fund Manager reserves the right to increase the number of companies to more than 20.
Options	Retail Option and Institutional Option I
Sub-Options	Retail: Growth and Dividend (Payout and Reinvestment) Institutional Option I: Growth
Min. Application Amount	Retail: Rs.5000 and in multiples of Re.1 thereafter Institutional Option I: Rs.10 crores and in multiples of Re.1 thereafter
Entry Load	Retail: (i) For investments of less than Rs.5 Crores: 2.25% of applicable NAV (ii) For investments of Rs.5 Crores and above: Nil Institutional Option I: Nil
Exit Load	Retail: (i) For investments of Rs.5 Crores and above: Nil (ii) For investments of less than Rs.5 Crores made during the NFO period and redeemed before 6 months from the date of allotment: 1% of applicable NAV. Institutional Option I: Nil
Recurring Expenses	Retail: Upto 2.5% Institutional Option I: Upto 2.5%
NFO Period	**April 8, 2008 to May 7, 2008**

Risks

Concentration Risk: Since this fund will invest in only about 20 stocks concentration risk is expected to be high however, since it will be a multi-sectoral fund without any sector bias sector-specific risk is expected to be relatively low.
Market Risk: The scheme is vulnerable to movements in the prices of securities invested by the scheme, which could have a material bearing on the overall returns from the scheme.
Derivatives Risk: Derivatives are highly leveraged instruments. Even a small price movement in the underlying security could have a large impact on their value.