

Mutual funds

Introduction

A mutual fund is a trust that collects money from a group of people or investors with similar investment objectives and then pools the collected money and gives it to a professional firm called a money manager or an investment management to invest on your behalf.

The investment manager invests the money in stocks, bonds, etc. and takes a fee (usually a percentage of the investments) for his service. Mutual funds offer a simple and effective way to put money in a number of financial investments that no one investor could afford. For example, a mutual fund could invest in your favorite stocks, which if you went to buy on your own would cost you huge amount. But since several other likeminded investors invest with you in the mutual fund, you get to own many of your stocks without having to invest huge amounts. For example, if you like HDFC stock, which trades around Rs 2500 and you have Rs 10000 available to invest. Now if you went ahead to invest directly into the stocks, you will get only 4 shares of HDFC with Rs 10000. But if you same amount invest in a mutual fund that has invested in HDFC shares along with few other stocks, and the fund holds 100 shares of HDFC, with your Rs 10000 you will not only get exposure to 100 shares of HDFC but will also get the benefits of other shares in the mutual fund to the extend of your investment.

A mutual fund provides diversification, professional management and liquidity. Diversification reduces the risk that negative performance of one type of investment will result in a significant loss to the mutual fund and erosion of your own money in the fund.

Say you buy 100 shares of Reliance Industries (RIL) for Rs 1,00,000. RIL reports negative news and the share price falls 20 per cent. You lose Rs 20,000. Had you invested in a mutual fund which had RIL among other stocks, RIL's fall could have been balanced by another share's rise or at least the loss would not have been as large. The flipside of course is that had the share done ell, you would have gained handsomely whereas the gain would have been smaller for the mutual fund. If you are like most investors though, you would like to limit your losses.

Mutual funds are managed by professional portfolio managers, who have the education and experience to research and pick investments with the best potential and those that meet the mutual fund's investment objective. And for a busy person like you, that means less time researching individual shares and bonds or spending big bucks on an investment adviser.

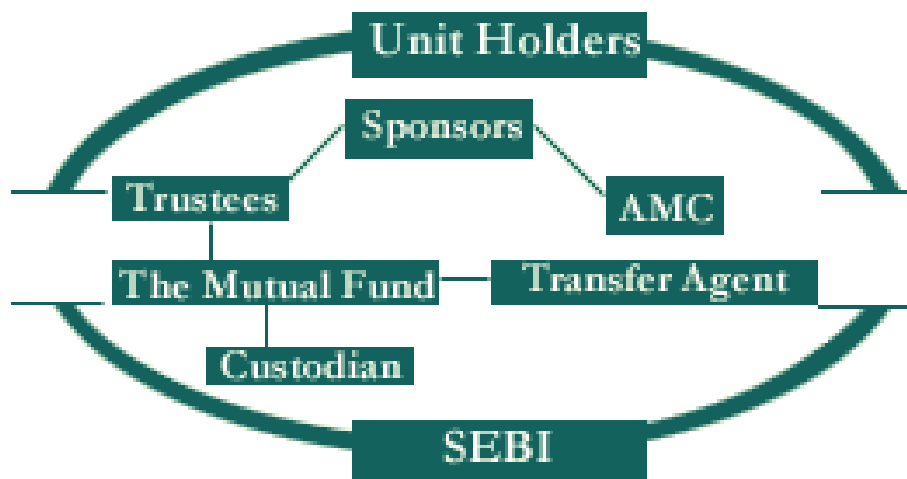
And let's not forget the liquidity of mutual funds or the ability to get your money back within two or three days. Unlike fixed deposits with banks or company deposits, mutual funds shares/units can be sold back to the mutual fund and your funds withdraw in some cases by just making a phone call. A note of caution though-a fund's unit price and return will vary, and you may have a gain or loss on selling your mutual fund units.

The biggest advantage with mutual funds is that you don't need huge amounts to be invested in all your favorite stocks or bonds. Most mutual funds have a minimum investment of Rs 2,000 and Rs 500 per month for SIP.

The other advantage of a mutual fund is that you can choose fund that suits your risk level. For example, if you are conservative you could select one that invests in government bonds. On your own you would not even be able to buy government bonds since they are available only if you buy large amounts. If you are an aggressive investor, you could find a mutual fund that invests in shares. And if you are placing your bets on certain sector like power, you can simply buy a mutual fund that invests specifically in shares in the power sector.

The mechanics of a mutual fund A mutual fund is set up as a trust that gives your money (and the money of thousands of other investors who invest in the fund) to a professional manager of investments (a company called an asset management company). For its services, the asset management company gets a fee (usually 1-1.25 per cent of the funds it manages or advises). The asset management company invests the money that the mutual fund collects from investors based on the mutual fund's investment objective. All mutual funds have an investment objective-i.e. to invest in shares, to invest in bonds, to invest in power companies, etc. and in what proportion. The AMC will usually buy bonds or stocks of at least twenty or thirty companies and the return will be paid to investors in proportion to their investments (excluding the fund manager's fee). AMCs also handle all the operations and day-to-day administration of the fund like marketing, calculating NAVs, keeping accounts and other activities. Each mutual fund family could have a number of investment schemes or funds. For example, the same mutual fund could have an equity fund, a bond fund and a balanced fund. Each scheme may be managed by a separate fund manager or a group of fund managers may manage all or some of the schemes.

There are many entities involved and the diagram below illustrates the organizational set up of a mutual fund:



Organization of a Mutual Fund

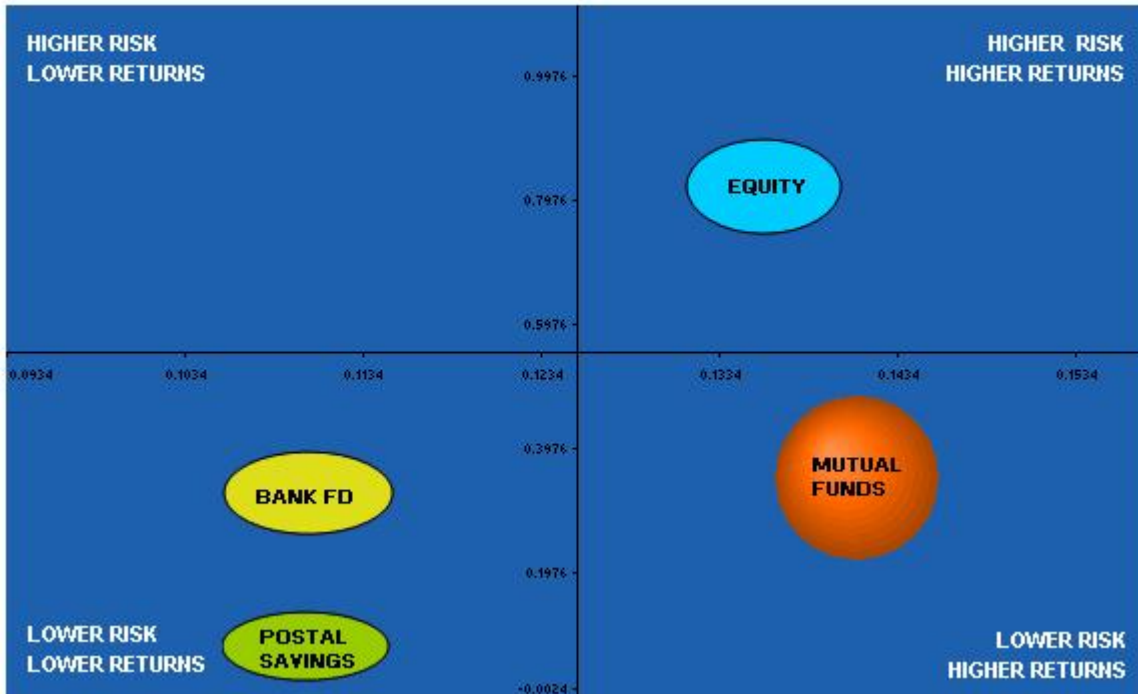
The sponsors, who are usually the parent company of the trustees, collect the pool of money from the unit holders and give it to the trustees. Trustees in turn give it to the AMC, which is again a subsidiary of the sponsor, who manages the unit holders' money. The AMC invests the collected money into the capital market instruments like stocks, bonds, commodities, etc. according to the objective of the mutual fund's scheme. The custodian is the body that holds the investments that are bought by the AMC. SEBI is the governing body who regulates the working of the mutual fund industry.

The safety aspect Mutual funds are one of the safest investments available today. Money in a mutual fund is not insured. But it is safe. Investor money is held by third party called a custodian and not by the mutual fund company. In other words, a mutual fund cannot use your money to cover up its financial problems. The money can only be used to make investments conforming to the mutual fund's investment objective.

Even though the value of the fund (called the Net Asset Value or NAV) may fluctuate based on the change in value of the stocks, bonds or securities that it buys, a mutual fund will rarely go bankrupt. That's because it is diversified into so many different securities that it will require most of the companies it invests in to go bankrupt at the same time which is very remote possibility. There are many checks and balances in the mutual fund industry to make sure your money is safe. The mutual fund industry is regulated by Securities and Exchange board of India (SEBI) and has to maintain a strict separation of functions. The asset management company, also called the fund manager, does not keep custody of the share certificates or securities that it buys for investors. The securities are kept in custody with an independent third party called custodian. The custodian has no authority to sell or deal in the securities but can only release them or accept them on the instructions of the AMC. Moreover, SEBI

inspects the workings of mutual funds from time to time to make sure that investor funds are being invested with due care.

Risk Return Matrix



The risk return trade-off indicates that if investor is willing to take higher risk then correspondingly he can expect higher returns and vice versa if he pertains to lower risk instruments, which would be satisfied by lower returns. For example, if an investor opts for postal savings, which provide lower return with minimal risk. But as he moves ahead to invest in bank FD that give out relatively more return, the risk is slightly higher as compared to the postal savings. Similarly, if the investor invests in equities, the risk is very high but the expected returns are also high.

Thus investors choose mutual funds as their primary means of investing, as Mutual funds provide professional management, diversification, convenience and liquidity. That doesn't mean mutual fund investments risk free. This is because the money that is pooled in are not invested only in debts funds which are less riskier but are also invested in the stock markets which involves a higher risk but can expect higher returns. Thus through diversification, mutual fund manages to achieve a position of earning a better return than bank FD, and at the same time maintaining a low risk profile.

Things to remember before buying a Mutual Fund

What about liquidity? Mutual funds are the most liquid investments available today and are as liquid as a bank fixed deposit. Most mutual funds give you a cheque within 72 hours of your request for withdrawal. Your withdrawal is made on the NAV as of the date of your request (make sure your request is in by noon for most mutual funds to give you that day's NAV). Money market mutual funds do even better. They give you a cheque within 24 hours or many of them allow you to write a cheque to the extent of your investments.

Mutual funds provide great tax benefits Dividends from mutual funds are tax-free. That's a great benefit. No need to find shares that pay dividends. If you invest in a debt fund, it's like getting tax-free interest since dividends from even a mutual fund that invests in debt are not taxable.

Compare before you buy Mutual fund performance data is usually published daily in the business newspapers. If you don't subscribe to a business newspaper, just browse through the website called www.amfiindia.com which collects data on every mutual fund scheme in India and gives NAV on daily basis.

However, compare performance of similar funds. Don't compare bond funds with stock funds. Within bond or equity funds, compare funds that invest in similar securities. For example, it is no use comparing the return on a gilt fund with regular bond fund. The bond fund will in most cases give higher returns than the gilt fund but may also carry higher risks. Compare a gilt fund from one mutual fund family with gilt fund from another mutual fund family.

Once you have scanned the performance data and decided to go for a mutual fund, call up the mutual fund and ask them to fax you a write-up on the fund, its returns, investment objectives, holdings, etc. Most mutual funds publish a monthly newsletter with updates on such information. If you are buying a mutual fund for the first time, I would also request a fund prospectus from the fund. A prospectus is an information document that gives the investment objectives of the mutual fund, a description of the fund's operation, information on its board and management and other information on the investing and withdrawing money from the fund.

One last thing, check with few people to see how they feel about the mutual fund's service standards. Performance is fine, but a mutual fund that has poor servicing is not worth your money.

Types of Mutual Funds Schemes in India

Wide variety of Mutual Fund Schemes exists to cater to the needs such as financial position, risk tolerance and return expectations etc. thus mutual funds has Variety of flavors, Being a collection of many stocks, an investors can go for picking a mutual fund might be easy. There are over hundreds of mutual funds scheme to choose from. It is easier to think of mutual funds in categories, mentioned below.

Overview of existing schemes existed in mutual fund category: BY STRUCTURE

1. Open - Ended Schemes:

An open-end fund is one that is available for subscription all through the year. You can buy any number of additional units even after its new fund offer directly from the mutual fund company. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. The key feature of open-end schemes is liquidity.

2. Close - Ended Schemes:

These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unitholder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

3. Interval Schemes:

Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

Overview of existing schemes existed in mutual fund category: BY NATURE

1. Equity fund:

These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may vary different for different schemes and the fund manager's outlook on different stocks. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- **Diversified Equity Funds** - These funds invests in equities of wide range of companies spread across different sectors. The goal is to minimize the risk by not concentrating on one or two sectors, but to spread investment across different companies in different sectors.

For example, JM Equity fund, HSBC Dynamic, LICMF Equity, JP Morgan India Equity, UTI Equity, etc. are diversified equity funds.

- **Market cap Funds** – These types of funds invest in specific group of companies based on their market capitalization. The companies are generally grouped into large cap, mid cap

and small cap. According to the objective of the fund, the fund manager will invest in either large cap or mid cap or small cap companies in his fund. Usually the names of the funds are obvious enough to identify their category.

For example, JM Large cap, Kotak 30, etc are large cap funds, similarly Magnum Mid-cap, ING Mid-cap, Tata Mid-cap are mid cap funds and L&T small cap, HSBC small cap, DSPBR micro cap are small cap funds.

- **Sector Specific Funds** – Sector specific funds invest in particular industry sectors like information technology, pharmaceuticals or consumer goods. Keep away from sector funds because they provide no diversification and in most cases they tend to be more volatile than most other mutual funds. That's because most stocks in the same industry sector usually suffer from the same problems or gain for the same reasons. But if you are really optimistic about a particular sector, it may not hurt to put up to 5-10 per cent of your investible funds in a sector specific fund.

For example, UTI Banking sector Reg, Franklin Pharma, ICICI Prudential Infrastructure, etc. are sector specific funds.

- **Tax Savings Funds (ELSS)** – You can reduce your taxable income by 20 per cent of your investment up to a maximum of Rs 2,000 by investing in mutual funds schemes that are authorized to offer such benefit like equity linked saving schemes. These schemes are just like any other equity or bond scheme except that it gives 20 per cent tax break. The condition is that you cannot withdraw your funds from the scheme for three years.

For example, LICMF Tax plan, UTI Equity Tax Savings, IDFC Tax Advantage (ELSS), etc. are tax saving funds.

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix.

2. Debt funds:

The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further classified as:

- **Gilt Funds:** Gilt funds invest in Government of India and state government securities and bonds that are guaranteed by the central and state governments. These mutual funds are the safest type of debt funds available since they invest in bonds backed by the full faith of the government. Your original investment is as safe as it can be though your returns may be lower than what you can get in a debt mutual fund that invests in corporate debt. Since for

all practical purposes most of us cannot participate in the bond market because of the size of each trade and because most brokers cater only to very large investors, gilt funds give you an excellent opportunity to invest in the safest of all investments.

- **Income Funds:** Income fund emphasis on current income as opposed to capital appreciation. They invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities. Generally the bonds included in their portfolio are of investment grade. The other securities are of sufficient credit quality to assure capital preservation.

For example, Tata Fixed Income Portfolio Scheme B2 Reg, HDFC Floating Rate Income Fund-Short Term Plan - Wholesale Option, ICICI Prudential Floating Rate Plan-Daily Dividend Option, etc are income funds.

- **High Yield Bond funds:** These funds pay higher returns than other bond funds, but invest all or part of their funds in riskier bonds like those that may not have the highest safety rating from credit rating agencies. The risk that a bond or bonds in the fund's portfolio could default is greater.
- **MIPs:** Monthly income plans are the funds that invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. They earn most of their income in form of interest and dividend. The primary objective of this type of fund is to earn regular income, though not fixed. This type of fund is suitable for retired people or for those who want extra monthly income to supplement their total income. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.

For example, HDFC MF Monthly Income Plan-Long Term Plan-Growth Option, IDFC Monthly Income Plan - Dividend Option, JM MIP FUND-Monthly Dividend, etc. are monthly income plan funds.

- **Fixed Maturity Plans (FMPs)/Short Term Plans (STPs):** A closed-end fund that invests in debt and money market instruments of the same maturity as the stated maturity of the plan. Hence they are least exposed to interest rate risk. The focus of a fixed maturity plan is to provide a stream of income through interest payments, while exposing the investor to a lower level of risk.

Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

For example, JM Fixed Maturity Fund - Series XIII - Monthly plan 1 (JM FMF - XIII - M1) - Regular plan - Growth option, UTI Fixed Maturity Plan - Half Yearly March 08- Dividend Option, LICMF FIXED MATURITY PLAN SERIES 37 (GROWTH OPTION), etc. are Fixed maturity plan funds.

- **Money market or Liquid Funds:** Money market funds are as safe as your savings bank

account and produce a much better return. They should be used as an alternative to savings bank accounts. You can withdraw your money within 24 hours from these funds and they allow you to write cheque on your balance. It means that you can get a cheque book and you can write a cheque against your investment. Money market funds invest most of their money in call money, a technical term for borrowings between banks for a day, treasury bills, certificates of deposits and fixed deposits. And you don't have to worry about your original investment. It will remain intact because this is the overriding concern the fund has and it sacrifices greater returns by picking absolutely safe short-term investments.