



UNDERSTANDING MUTUAL FUNDS



Mutual Fund Basics

A Mutual Fund is a trust that collects money from investors who share a common financial goal, and invest the proceeds in different asset classes, as defined by the investment objective. Simply put, mutual fund is a financial intermediary, set up with an objective to professionally manage the money pooled from the investors at large.

By pooling money together in a mutual fund, investors can enjoy economies of scale and can purchase stocks or bonds at a much lower trading costs compared to direct investing in capital markets. The other advantages are diversification, stock and bond selection by experts, low costs, convenience and flexibility.

An investor in a Mutual Fund Scheme receives *units* which are in accordance with the quantum of money invested by him. These units represent an investor's proportionate ownership into the assets of a scheme and his liability in case of loss to the fund is limited to the extent of amount invested by him.

The pooling of resources is the biggest strength for mutual funds. The relatively lower amounts required for investing into a mutual fund scheme enables small retail investors to enjoy the benefits of professional money management and lends access to different markets, which they otherwise may not be able to access.

The investment experts who invest the *pooled* money on behalf of investors of the scheme are known as Fund Managers. These fund managers take the investment decisions pertaining to the selection of securities and the proportion of investments to be made into them. However, these decisions are governed by certain guidelines which are decided by the investment objective(s), investment pattern of the scheme and are subject to regulatory restrictions. It is this investment objective and investment pattern which also guides the investor in choosing the right fund for his investment purpose. Today, there are a variety of schemes offered by mutual funds in India, which cater to different categories of investors to suit different financial objectives e.g. some schemes may provide capital protection for the risk-averse investor, whereas some other schemes may provide for capital appreciation by investing in small cap segment of the equity market for the more aggressive investor.

The diversity in investment objectives and mandates has helped to classify and sub-classify the schemes accordingly. The broad classification can be done at the asset class levels: thus we have Equity Funds, Bond Funds, Liquid or Money Market Funds, Balanced Funds, Gilt Funds etc. These can be further sub-



classified into different categories like mid cap funds, small cap funds, sector funds, index funds etc.

How are Mutual Funds set up?

A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and Custodian. The trust is established by a sponsor or more than one sponsor who is like a promoter of a company and registered with Securities and Exchange Board of India (SEBI). The trustees of the mutual fund hold its property for the benefit of the unit holders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over the AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent.

Types of Mutual Fund schemes:

Mutual Fund schemes can be classified into different categories and sub-categories based on their investment objectives or their maturity periods.

A) Classification based on maturity period:

Mutual Fund schemes can be classified into three categories based on their maturity periods.

Open-ended schemes

These are mutual fund schemes which offer units for purchase and redemption subscription on a continuous basis. In other words, the units of these schemes can be purchased or redeemed at any point of time at Net Asset Value (NAV) based prices. Also, these schemes do not have a fixed maturity period and an investor can redeem his units anytime.



Close-ended schemes

These are mutual fund schemes which have a defined maturity period e.g. 1 year / 5 years etc. The units of close ended scheme can be bought only during a specified period at the time of initial launch. SEBI stipulates that all close-ended schemes should provide for a liquidity window to its investors. These schemes are either required to be listed on a recognized stock exchange or provide periodic repurchase facility to investors.

Interval schemes

These schemes are a cross between an open-ended and a close-ended structure. These schemes are open for both purchase and redemption during pre-specified intervals (viz. monthly, quarterly, annually etc.) at the prevailing NAV based prices. Interval funds are very similar to close-ended funds, but differ on the following points.

- They are not required to be listed on the stock exchanges, as they have an in-built redemption window.
- They can make fresh issue of units during the specified interval period, at the prevailing NAV based prices.
- Maturity period is not defined.

Classification based on investment objective

Apart from the above classification, mutual fund schemes can also be classified based on their investment objectives:

Equity Oriented Schemes

Growth/ Equity oriented schemes are those schemes which predominantly invest in equity and equity related instruments. The objective of such schemes is to provide capital appreciation over the medium to long term. These types of schemes are generally meant for investors with a long-term outlook and with a higher risk appetite.

Debt Oriented schemes

The main objective of debt-oriented funds is to provide regular and steady income to investors. These schemes mainly invest in fixed income securities such as Bonds, Money Market Instruments, Corporate Debentures, Government



Securities (Gilts) etc. Debt-oriented schemes are suitable for investors whose main objective is safety of capital along with modest growth. These funds are not affected because of fluctuations in equity markets. However, the NAV of such funds is affected because of change in the interest rate in the country.

Balanced Fund

Balanced Funds provide the best of both worlds i.e. equity and debt. The aim of the balanced funds is to provide both capital appreciation and stability of income in the long run. The proportion of investment made into equities and fixed income securities is pre-defined and mentioned in the offer document of the scheme. This type of scheme is a good alternative for pure equity-oriented products and provides an effective asset allocation tool. These schemes are suitable for investors looking for moderate growth. NAVs of such funds are generally less volatile in nature compared to pure equity funds.

Gilt Funds

These Funds invest exclusively in the dated securities issued by the government. These funds carry a very minimal risk because they are free of any default or credit risk. However, they do carry an interest rate risk as is the case with other debt products.

Money Market/ Liquid Funds

These are predominantly debt-oriented schemes, whose main objective is preservation of capital, easy liquidity and moderate income. To achieve this objective, liquid funds invest predominantly in safer short-term instruments like Commercial Papers, Certificate of Deposits, Treasury Bills, G-Secs etc. These schemes are used mainly by institutions and individuals to park their surplus funds for short periods of time. These funds are more or less insulated from changes in the interest rate in the economy and capture the current yields prevailing in the market.

Fund of Funds

Fund of Funds (FoF) as the name suggests are schemes which invest in other mutual fund schemes. The concept is popular in markets where there are number of mutual fund offerings and choosing a suitable scheme according to one's objective is tough. Just as a mutual fund scheme invests in a portfolio of securities such as equity, debt etc, the underlying investments for a FoF is the



units of other mutual fund schemes, either from the same fund family or from other fund houses.

New Product categories

Capital Protection Oriented schemes

The term 'capital protection oriented scheme' means a mutual fund scheme which is designated as such and which endeavours to protect the capital invested therein through suitable orientation of its portfolio structure. The orientation towards protection of capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover etc. SEBI stipulations require these type of schemes to be close-ended in nature, listed on the stock exchange and the intended portfolio structure would have to be mandatory rated by a credit rating agency. A typical portfolio structure could be to set aside major portion of the assets for capital safety and could be invested in highly rated debt instruments. The remaining portion would be invested in equity or equity related instruments to provide capital appreciation. Capital Protection Oriented schemes are a recent entrant in the Indian capital markets and should not be confused with 'capital guaranteed' schemes.

Gold Funds

The objective of these funds is to track the performance of Gold. The units represent the value of gold or gold related instruments held in the scheme. Gold Funds which are generally in the form of an Exchange Traded Fund (ETF) are listed on the stock exchange and offers investors an opportunity to participate in the bullion market without having to take physical delivery of gold.

Real Estate Mutual Funds

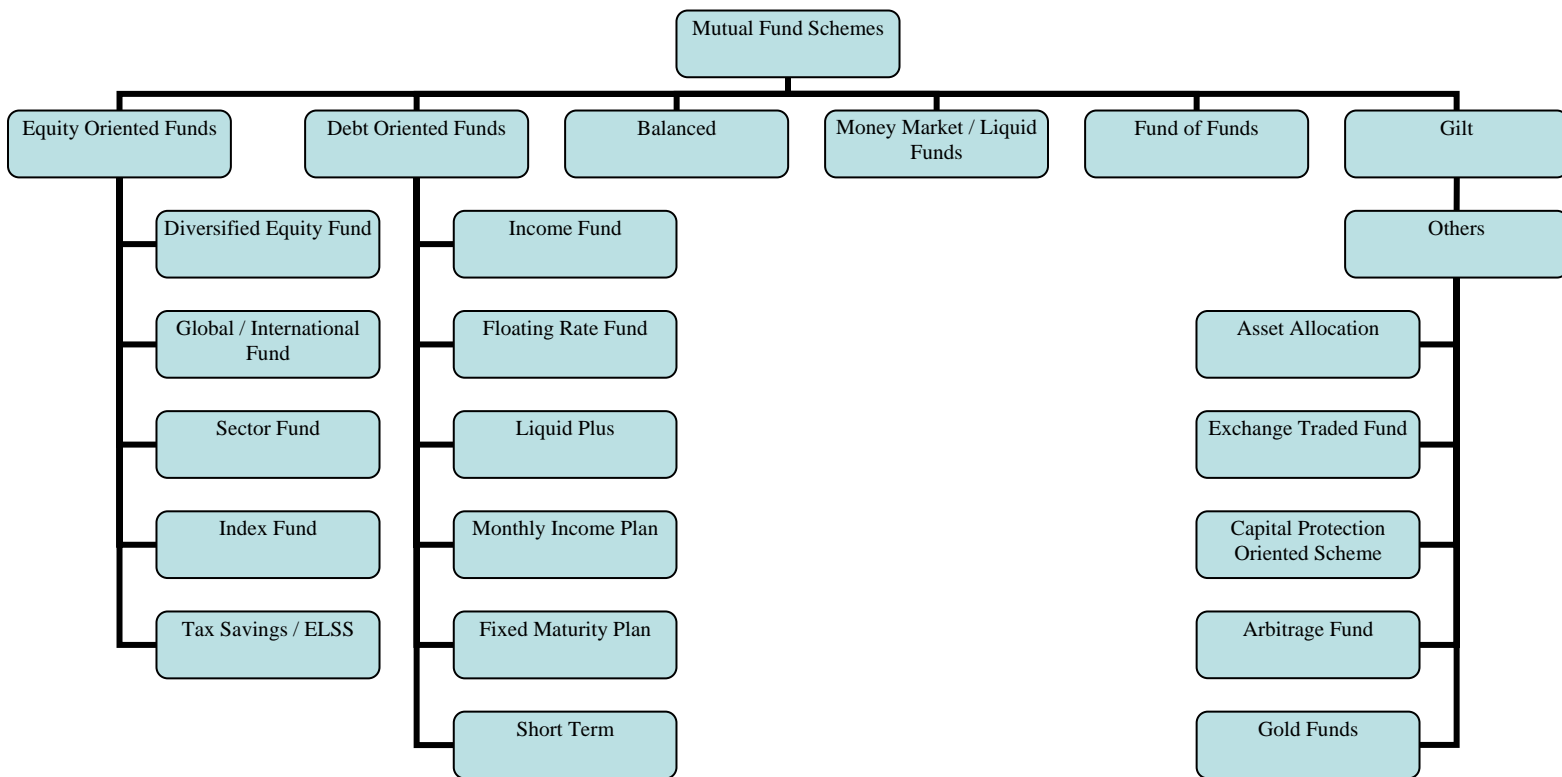
Real Estate Mutual Funds or realty funds as they are popularly known are the latest addition to the mutual fund offerings in India. SEBI recently paved way for the launch of such products, by making amendments to its existing Regulations. However, real estate mutual funds are yet to be introduced in India by any asset management company. These schemes invest in real estate properties and earn income in the form of rentals, capital appreciation from developed properties. Also some part of the fund corpus is invested in equity shares or debentures of companies engaged in real estate assets or developing



real estate development projects. REMFs are required to be close-ended in nature and listed on a stock exchange.

Classifications Continued.....

In addition to the above broad classification, mutual fund schemes can be further classified into sub-categories. Each of the sub-categories has a stated objective and caters to specific requirements of investors.



Investment options available to investors

Growth Option

Under growth option, dividends are not paid out to the unit holders. Income attributable to the Unit holders continues to remain invested in the Scheme and is reflected in the NAV of units under this option. Investors can realize capital appreciation by way of an increase in NAV of their units by redeeming them.



Dividend Payout Option

Dividends are paid out to the unit holders under this option. However, the NAV of the units falls to the extent of the dividend paid out and applicable statutory levies.

Dividend Re-investment Option

The dividend that accrues on units under option is re-invested back into the scheme at ex-dividend NAV. Hence investors receive additional units on their investments in lieu of dividends.

Benefits of Mutual Fund

There are two major reasons why most people around the globe are afraid to take investment decisions on their own. One of them is the lack of time to study the pros and cons of different investment opportunities and the other being lack of financial know-how. Apart from that, some financial markets have a steep entry barrier, which prevents a small ticket investor from participating in the growth of that sector. Investment needs across different category of investors are also not common. While some may settle for safety of capital, others may chase returns. There may be others who would want their capital to grow at a steady pace, while some may want to save for retirement or child's education. The need and objective of the investors are truly diverse and any one financial product can't fulfill all of them. The emergence of mutual funds in the past decade as a popular investment vehicle is due to the fact that it serves broadly all categories of investors through the plethora of schemes that it offers. The benefits provided by mutual funds far outweigh its shortcomings, and has thus gained wide-spread acceptance.

Benefits of investing in Mutual Funds

Professional Management: Mutual funds provide the benefit of professional management as people's money is managed by experienced fund managers. Investors, who do not have time, inclination and the know-how to manage their investments, can look towards mutual funds as an alternative. It is inexpensive and is ideal for a small ticket investor.

Economies of scale: The way mutual funds are structured gives it a natural advantage. The "pooled" money from a number of investors ensures that mutual funds enjoy economies of scale; it is cheaper compared to investing directly in the capital markets which involves higher charges. This also allows



retail investors access to high entry level markets like real estate, and also there is a greater control over costs.

Diversification: Mutual funds provide investors with the benefit of diversification across different companies and sectors. Diversification in simple terms means to spread your portfolio across different sectors, industries and companies so that the overall portfolio is relatively safeguarded from downturns in one or more sectors. Since small investors do not have enough money to make meaningful investments across different assets, a mutual fund does the job for them.

Liquidity: Open ended mutual funds provide easy liquidity and investors can buy or sell units anytime, at the prevailing NAV based prices. Close-ended schemes also provide periodic repurchase facility or are listed on a stock exchange where investors can redeem their units at the prevailing market price. Interval funds which are a cross between a close-ended and an open-ended structure also provide periodic liquidity option to its investors.

Flexibility: There are a lot of features in a regular mutual fund scheme, which imparts flexibility to the scheme. An investor can opt for Systematic Investment Plan (SIP), Systematic Withdrawal Plan etc. to plan his cash flow requirements as per his convenience. The wide range of schemes being launched in India by different mutual funds also provides an added flexibility to the investor to plan his portfolio accordingly.

Transparency: The mutual fund industry in India works on a very transparent basis, and various kind of information are available to their investors, through fact sheets, offer documents, annual reports etc.

Well Regulated: Indian Mutual Fund industry is well regulated by the Securities and Exchange Board of India (SEBI). This helps to instill confidence and provides comfort to the investors. The regulatory environment in India is quite healthy, and ensures transparency in the processes and transactions.

The best practices adopted by the industry in India have helped them win investors' confidence over the years. The ease and convenience which mutual funds offer and the different variety of schemes made available to the investors creates popularity for mutual funds, which cuts across investor classes and creates a favourable appeal

Mutual Fund Myths

Common myths associated with mutual fund investing

There are few myths and misconceptions associated with investing in mutual fund schemes. Some of these notions have faded over time, as investor awareness has increased but some continue to hold strong. It is imperative to dispel these myths as investments should not be made under wrong impressions. It can throw the best laid out financial plan out of control, and the situation can be avoided with a little bit of caution.

Lower NAV is cheaper

The most common myth that is prevalent among mutual fund investors is that of associating a scheme with a lower NAV being a better buy compared to a scheme with a higher NAV. This stems from the mindset of equating mutual fund units with equity shares of a company. NAV of a Scheme is irrelevant and irrespective of whether we are investing into a fund having a low NAV or a fund with a higher NAV, the amount of investment remains the same.

Let's look at a hypothetical investment into two schemes A and B. Scheme A has a NAV of Rs 10 whereas scheme B has a NAV of Rs 200. We made equal amount of investment of Rs. 1 lac each in both the schemes. Scheme A would come across as a cheaper buy because we got 10,000 units as against 500 units in scheme B. Now, let us assume that both the scheme grows by 10 % in a month. The NAV for scheme A is Rs 11 and Scheme B has a NAV of Rs 220. The value of your investment in both the case is Rs 1,10,000. Therefore, we see that the NAV of a scheme is irrelevant, as far as generating returns is concerned. The only difference being in case of the former, the investor gets more units and in the latter, he gets lesser units. For two schemes with identical portfolio and other things remaining constant, the difference in NAV will hardly matter and both the schemes will grow at the same rate.

Regular dividends means good performance

Another popular myth which emerges due to the linkages we make between the concepts of a stock markets and mutual funds is the dividend payout mechanism. When a company pays dividend, in effect it is transferring a certain portion of its surplus to its share holders. Therefore a generous dividend payout policy could be considered favourable in case of a company. However, in case of mutual funds, dividends are declared out of the distributable surplus which is included in calculation of net asset value. In



effect it is paying back a certain portion of net assets from our own investments. Therefore, dividends from mutual fund units don't make us any richer, as there are no additional gains to be made. The NAV of the scheme falls to the extent of the dividend payout, when a scheme pays dividend. Thus, a scheme with a high dividend payout record does not necessarily mean that it is performing well. Dividend option may prove important to plan cash flows, especially in the case of tax savings scheme which have a lock-in period and also for tax incidence.

Demat account is required for MF investments

Except in case of Schemes which are listed on the stock exchange, demat account is not required to own units in a mutual fund scheme.

Past performers are the best funds to buy

Despite the disclaimers, mutual fund investors tend to invest in the top performing scheme of the last year, hoping that past performance will ensure that the scheme continues to stay at the top. However, empirical studies have shown that no scheme has been able to do that successfully and consistently. Therefore instead of chasing the top performer in the short term, it is advisable to invest in a scheme which features in the top quartile consistently over a longer period of time. In addition to past performance, the investors should also consider other factors viz. professional management, service standards etc.

Fees and Expenses

As is the case with any other business, running a mutual fund business also involves costs. The various costs incurred by a mutual fund could be associated with transactions made by investors, operating costs, marketing and distribution expenses etc.

Expenses borne by the Mutual Fund investor can be broadly classified into two categories. The load which is charged to the investor at the time of subscription or redemption and the recurring expenses which are charged to the fund.

Loads or Sales Charges

Loads are charges which investors incur when they buy/ redeem units in a mutual fund scheme. A load charged at the time of purchase is known as 'Entry Load or Front End Load' and charged at the time of redemption is known as 'Exit Load or Back End



Load'. Asset management companies charge these loads to defray the selling and distribution expenses including commission paid to the agents/distributors.

However, an investor is not required to pay entry load where an application is not routed through any agent or distributor. (Direct application)

Expenses related to New Fund Offer (NFO) have to be met from the entry load collected from the investors and cannot be charged to the investor through initial issue expenses route. Any excess expenses over the entry load collected have to be borne by the AMC, Sponsor or the Trustee.

Recurring Expenses

These are costs incurred for day to day operation of a scheme. These expenses inter-alia include investment management and advisory fees, trustee fees, registrar's fees, custodian's fees, Audit fees, marketing and selling expenses including agents' commission etc.

The recurring expenses (including investment management fees) that can be charged to the scheme are subject to following limits (as a percentage of weekly average net assets):

First Rs 100 crores	Next Rs 300 crores	Next Rs 300 crores	Balance
2.50%	2.25%	2.00%	1.75%

In case of schemes other than equity oriented schemes, the above limits are less by 0.25%. For Fund of Funds Scheme, the recurring expenses limit is 0.75%.

- **Management Fees**

Management fees are the charges levied on the fund by the asset management company for providing investment management and advisory services.

The Management Fees that can be charged by the asset management company is subject to following limits:

Weekly average net assets	Maximum limit
First Rs 100 crores	1.25 %
Balance	1.00 %

For Index funds, however, the management fees shall not exceed 0.75 % of the weekly average net assets.

For schemes launched on a no-load basis, the AMC is entitled to charge an additional management fee of 1% of the weekly average net assets outstanding in each financial year.



For balanced schemes, the applicable limit would depend on whether the scheme is predominantly equity-oriented or debt-oriented. Any other costs and expenses associated with the fund, other than the one specified above has to be borne by the AMC itself, as per the guidelines of the regulator.

(Note: The management fees and recurring expenses can be levied on the basis daily average net assets also)