Chapter–7: Mutual Funds

Regulatory Body for Mutual Funds

Securities Exchange Board of India (SEBI) is the regulatory body for all the mutual funds. All the mutual funds must get registered with SEBI.

Benefits of investing in Mutual Funds

There are several benefits from investing in a Mutual Fund

Small investments: Mutual funds help you to reap the benefit of returns by a portfolio spread across a wide spectrum of companies with small investments.

Professional Fund Management: Professionals having considerable expertise, experience and resources manage the pool of money collected by a mutual fund. They thoroughly analyse the markets and economy to pick good investment opportunities.

Spreading Risk: An investor with limited funds might be able to invest in only one or two stocks/bonds, thus increasing his or her risk. However, a mutual fund will spread its risk by investing a number of sound stocks or bonds. A fund normally invests in companies across a wide range of industries, so the risk is diversified.

Transparency: Mutual Funds regularly provide investors with information on the value of their investments. Mutual Funds also provide complete portfolio disclosure of the investments made by various schemes and also the proportion invested in each asset type.

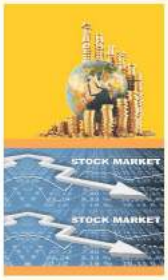
Choice: The large amount of Mutual Funds offer the investor a wide variety to choose from. An investor can pick up a scheme depending upon his risk/return profile.

Regulations: All the mutual funds are registered with SEBI and they function within the provisions of strict regulation designed to protect the interests of the investor.

NAV

NAV or Net Asset Value of the fund is the cumulative market value of the assets of the fund net of its liabilities. NAV per unit is simply the net value of assets divided by the number of units outstanding. Buying and selling into funds is done on the basis of NAV-related prices.

The NAV of a mutual fund are required to be published in newspapers. The NAV of an open end scheme should be disclosed on a daily basis and the NAV of a close end scheme should be disclosed at least on a weekly basis.



Risks involved in investing in Mutual Funds

Mutual Funds do not provide assured returns. Their returns are linked to their performance. They invest in shares, debentures, bonds etc. All these investments involve an element of risk. The unit value may vary depending upon the performance of the company and if a company defaults in payment of interest/principal on their debentures/bonds the performance of the fund may get affected. Besides incase there is a sudden downturn in an industry or the government comes up with new a regulation which affects a particular industry or company the fund can again be adversely affected. All these factors influence the performance of Mutual Funds.

Some of the Risk to which Mutual Funds are exposed to is given below:

Market Risk

If the overall stock or bond markets fall on account of overall economic factors, the value of stock or bond holdings in the fund's portfolio can drop, thereby impacting the fund performance.

Non-Market Risk

Bad news about an individual company can pull down its stock price, which can negatively affect fund holdings. This risk can be reduced by having a diversified portfolio that consists of a wide variety of stocks drawn from different industries.

Interest Rate Risk

Bond prices and interest rates move in opposite directions. When interest rates rise, bond prices fall and this decline in underlying securities affects the fund negatively.

Credit Risk

Bonds are debt obligations. So when the funds invest in corporate bonds, they run the risk of the corporate defaulting on their interest and principal payment obligations and when that risk crystallizes, it leads to a fall in the value of the bond causing the NAV of the fund to take a beating.

Different types of Mutual funds

Mutual funds are classified in the following manner:

(a) On the basis of Objective

Equity Funds/ Growth Funds

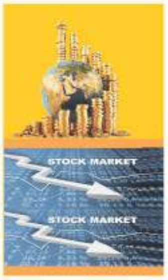
Funds that invest in equity shares are called equity funds. They carry the principal objective of capital appreciation of the investment over the medium to long-term. They are best suited for investors who are seeking capital appreciation. There are different types of equity funds such as Diversified funds, Sector specific funds and Index based funds.

Diversified funds

These funds invest in companies spread across sectors. These funds are generally meant for risk-averse investors who want a diversified portfolio across sectors.

Sector funds

These funds invest primarily in equity shares of companies in a particular business sector or industry. These funds are targeted at investors who are bullish or fancy the prospects of a particular sector.



Index funds

These funds invest in the same pattern as popular market indices like S&P CNX Nifty or S&P CNX 500. The money collected from the investors is invested only in the stocks, which represent the index. For e.g. a Nifty index fund will invest only in the Nifty 50 stocks. The objective of such funds is not to beat the market but to give a return equivalent to the market returns.

Tax Saving Funds

These funds offer tax benefits to investors under the Income Tax Act. Opportunities provided under this scheme are in the form of tax rebates under the Income Tax act.

Debt/Income Funds

These funds invest predominantly in high-rated fixed-income-bearing instruments like bonds, debentures, government securities, commercial paper and other money market instruments. They are best suited for the medium to long-term investors who are averse to risk and seek capital preservation. They provide a regular income to the investor.

Liquid Funds/Money Market Funds

These funds invest in highly liquid money market instruments. The period of investment could be as short as a day. They provide easy liquidity. They have emerged as an alternative for savings and short-term fixed deposit accounts with comparatively higher returns. These funds are ideal for corporates, institutional investors and business houses that invest their funds for very short periods.

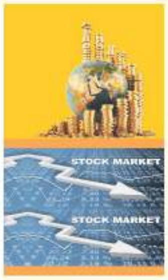
Gilt Funds

These funds invest in Central and State Government securities. Since they are Government backed bonds they give a secured return and also ensure safety of the principal amount. They are best suited for the medium to long-term investors who are averse to risk.

Balanced Funds

These funds invest both in equity shares and fixed-income-bearing instruments (debt) in some proportion. They provide a steady return and reduce the volatility of the fund while providing some upside for capital appreciation. They are ideal for medium to long-term investors who are willing to take moderate risks.

b) On the basis of Flexibility



Open-ended Funds

These funds do not have a fixed date of redemption. Generally they are open for subscription and redemption throughout the year. Their prices are linked to the daily net asset value (NAV). From the investors' perspective, they are much more liquid than closed-ended funds.

Close-ended Funds

These funds are open initially for entry during the Initial Public Offering (IPO) and thereafter closed for entry as well as exit. These funds have a fixed date of redemption. One of the characteristics of the close-ended schemes is that they are generally traded at a discount to NAV, but the discount narrows as maturity nears. These funds are open for subscription only once and can be redeemed only on the fixed date of redemption. The units of these funds are listed on stock exchanges (with certain exceptions), are tradable and the subscribers to the fund would be able to exit from the fund at any time through the secondary market.

What are the different investment plans that Mutual Funds offer

The term 'investment plans' generally refers to the services that the funds provide to investors offering different ways to invest or reinvest. The different investment plans are an important consideration in the investment decision, because they determine the flexibility available to the investor. Some of the investment plans offered by mutual funds in India are:

Growth Plan and Dividend Plan

A growth plan is a plan under a scheme wherein the returns from investments are reinvested and very few income distributions, if any, are made. The investor thus only realizes capital appreciation on the investment. Under the dividend plan, income is distributed from time to time. This plan is ideal to those investors requiring regular income.

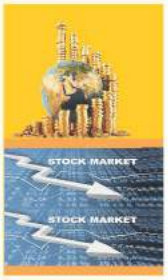
Dividend Reinvestment Plan

Dividend plans of schemes carry an additional option for reinvestment of income distribution. This is referred to as the dividend reinvestment plan. Under this plan, dividends declared by a fund are reinvested in the scheme on behalf of the investor, thus increasing the number of units held by the investors.

The rights that are available to a Mutual Fund holder in India

As per SEBI Regulations on Mutual Funds, an investor is entitled to:

1. Receive Unit certificates or statements of accounts confirming your title within 6 weeks from the date your request for a unit certificate is received by the Mutual Fund.
2. Receive information about the investment policies, investment objectives, financial position and general affairs of the scheme.
3. Receive dividend within 30 days of their declaration and receive the redemption or repurchase proceeds within 10 days from the date of redemption or repurchase.
4. The trustees shall be bound to make such disclosures to the unit holders as are essential in order to keep them informed about any information, which may have an adverse bearing on their investments.
5. 75% of the unit holders with the prior approval of SEBI can terminate the AMC of the fund.



6. 75% of the unit holders can pass a resolution to wind-up the scheme.
7. An investor can send complaints to SEBI, who will take up the matter with the concerned Mutual Funds and follow up with them till they are resolved.

Fund Offer document

A Fund Offer document is a document that offers you all the information you could possibly need about a particular scheme and the fund launching that scheme. That way, before you put in your money, you're well aware of the risks etc involved. This has to be designed in accordance with the guidelines stipulated by SEBI and the prospectus must disclose details about:

- Investment objectives
- Risk factors and special considerations
- Summary of expenses
- Constitution of the fund
- Guidelines on how to invest
- Organization and capital structure
- Tax provisions related to transactions
- Financial information

Active Fund Management

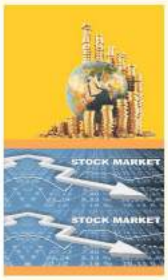
When investment decisions of the fund are at the discretion of a fund manager(s) and he or she decides which company, instrument or class of assets the fund should invest in based on research, analysis, market news etc. such a fund is called as an actively managed fund. The fund buys and sells securities actively based on changed perceptions of investment from time to time. Based on the classifications of shares with different characteristics, 'active' investment managers construct different portfolio. Two basic investment styles prevalent among the mutual funds are Growth Investing and Value Investing:

Growth Investing Style

The primary objective of equity investment is to obtain capital appreciation. A growth manager looks for companies that are expected to give above average earnings growth, where the manager feels that the earning prospects and therefore the stock prices in future will be even higher. Identifying such growth sectors is the challenge before the growth investment manager.

Value investment Style

A Value Manager looks to buy companies that they believe are currently undervalued in the market, but whose worth they estimate will be recognized in the market valuations eventually.



Passive Fund Management

When an investor invests in an actively managed mutual fund, he or she leaves the decision of investing to the fund manager. The fund manager is the decision-maker as to which company or instrument to invest in. Sometimes such decisions may be right, rewarding the investor handsomely. However, chances are that the decisions might go wrong or may not be right all the time which can lead to substantial losses for the investor. There are mutual funds that offer Index funds whose objective is to equal the return given by a select market index. Such funds follow a passive investment style. They do not analyse companies, markets, economic factors and then narrow down on stocks to invest in. Instead they prefer to invest in a portfolio of stocks that reflect a market index, such as the Nifty index. The returns generated by the index are the returns given by the fund. No attempt is made to try and beat the index. Research has shown that most fund managers are unable to constantly beat the market index year after year. Also it is not possible to identify which fund will beat the market index. Therefore, there is an element of going wrong in selecting a fund to invest in. This has lead to a huge interest in passively managed funds such as Index Funds where the choice of investments is not left to the discretion of the fund manager. Index Funds hold a diversified basket of securities which represents the index while at the same time since there is not much active turnover of the portfolio the cost of managing the fund also remains low. This gives a dual advantage to the investor of having a diversified portfolio while at the same time having low expenses in fund.

ETF

Think of an exchange-traded fund as a mutual fund that trades like a stock. Just like an index fund, an ETF represents a basket of stocks that reflect an index such as the Nifty. An ETF, however, isn't a mutual fund, it trades just like any other company on a stock exchange. Unlike a mutual fund that has its net-asset value (NAV) calculated at the end of each trading day, an ETF's price changes throughout the day, fluctuating with supply and demand. It is important to remember that while ETFs attempt to replicate the return on indexes, there is no guarantee that they will do so exactly.

By owning an ETF, you get the diversification of an index fund plus the flexibility of a stock. Because, ETFs trade like stocks, you can short sell them, buy them on margin and purchase as little as one share. Another advantage is that the expense ratios of most ETFs are lower than that of the average mutual fund. When buying and selling ETFs, you pay your broker the same commission that you'd pay on any regular trade.