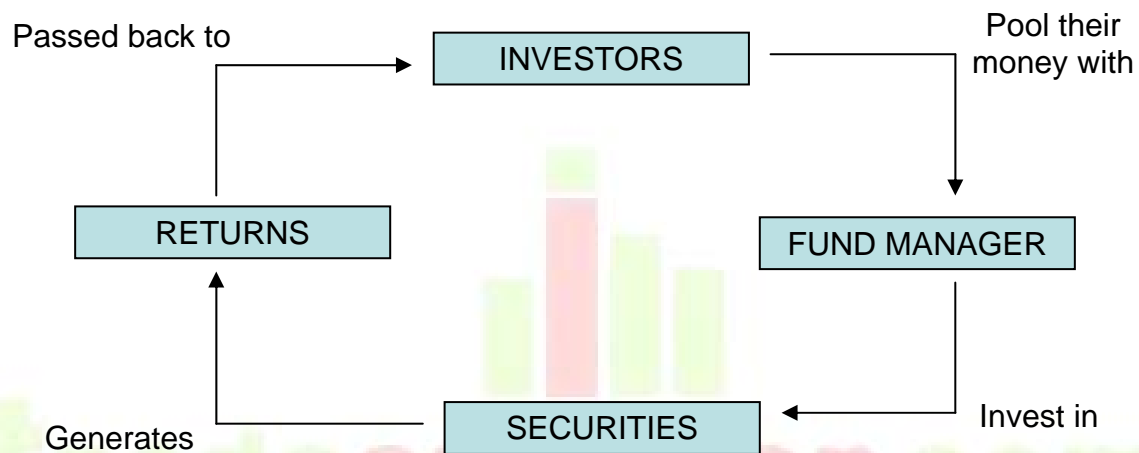


INTRODUCTION TO MUTUAL FUNDS

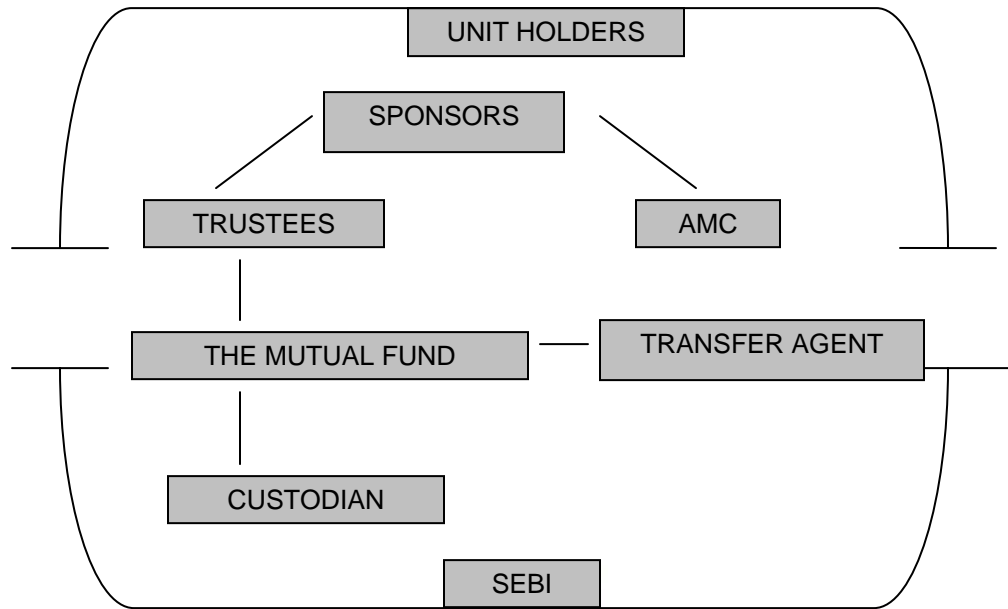
A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures or even in assets like real estate and gold and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them. In India a mutual fund is organized as a trust, and this trust in turn appoints an asset manager commonly called an Asset Management Company (AMC) to carry out the investment activity on its behalf.

The flow chart below broadly describes the working of a mutual fund:



Organization of a Mutual Fund

There are many entities involved in the organization of a mutual fund as depicted in the diagram below:



Determinants of Selecting a Fund

The following is a rough guide, while picking a mutual fund:

- **Research:** Check the return and risk of a fund against its peers with similar investment objectives, and against the index most closely associated with it. Be sure to pay attention to performance over both the long-term and the short-term. A fund that gained 53% over a 1-yr. period (which is impressive), but only 11% over a 5-yr. period should raise some suspicion, as that would imply that the returns on four out of those five years were actually very low (if not straight losses) as 11% compounded over 5 years is only 68%.
- **Investment Need:** It is necessary to decide the purpose for which the investment is being made. This is because the investment avenue can vary depending upon the needs of the potential investor. For instance if one is investing for some event like retirement or for marriage of children and there is plenty of time to go, then it is better to invest in equity-dominated funds.
- **Compounding:** A little money invested for a long time equals a lot of money later.
- **Risk Profile:** It is essential to invest in accordance with one's risk bearing capacity. Equity funds therefore are not suitable for those with little risk appetite as volatile equity markets can impact fund returns.
- **Time Frame of Investment:** Generally, equity funds are considered to be performers over a relatively long period of time. In the short-term they are prone to fluctuations of the market.
- **Liquidity:** If the time frame of investment is short then it is not really advisable to invest in close-ended schemes. On the other hand if one is willing to invest for a certain defined period a close-ended scheme may do the job. Further more, liquidity of the scheme in terms of its ability to liquidate its portfolio should also be considered.

- **Service Levels/Expenses:** It is important to choose a fund that offers efficient service in terms of prompt delivery of account statement and quick redressal of investor grievances. It is also important to keep in mind expenses like broker/dealer remuneration, audit fees, cost of funds transfer, cost of providing a/c statements, and cost of statutory advertisements while selecting a mutual fund.
- **Transparency:** It is better to choose a fund that is open about its investments, its investment style, and in its communication with its investors.

Costs Associated with Mutual Funds

In addition to loads, a mutual fund also charges asset management fees, and certain other expenses. These charges are fixed by the AMC and are meant to compensate the fund for the expenses it incurs in managing assets, processing transactions and paying brokerage.

- **Entry Load/Sale Load:** It is the charge imposed on the investor at the time of his entry into the fund. Thus, the investor has to pay for the value of the units plus an additional charge. This additional charge is called the entry/sale load. For example; In the case of HDFC Balanced Fund, if the investment amount is between Rs.0 and Rs.49,999,999 then entry load is 2.25%, and if it is greater than Rs.50,000,000 then entry load is 0%.
- **Exit Load/Repurchase Load:** It is the charge imposed on the investor at the time of his exit from the scheme. The mutual fund will pay back to the investor the value of the units reduced by the charge levied on exit. For example, in case of HDFC Children Gift Fund; if investment is redeemed between Year 0 and Year 1, exit load is 3%, if it is redeemed between Year 1 and Year 2 the exit load is 2% and if it is redeemed between Year 2 and Year 3 the exit load is 1%.
- **Contingent Deferred Sales Charge:** A mutual fund may not want to charge an exit load in all the cases. In such a case the AMC may impose charges based on the time of withdrawal. Thus, a fund desirous of long-term investors may stipulate that the exit charge will keep reducing with duration of investment. Such a charge is called Contingent Deferred Sales Charge. In order to charge a CDSC the scheme has to be a no load scheme as per the regulation laid down by SEBI. The idea behind charging CDSC is to recover expenses incurred on promotion or distribution of the scheme.
- **Switchover/Exchange Fee:** It is the fees charged by a fund when the investor decides to switch his investment from one scheme of the fund to another scheme from the same fund family.
- **Recurring Expenses:** Apart from loads, mutual funds also charge some other expenses which are usually covered by the above mentioned fees:
 - Investment Management & Advisory Fees: As the name suggests this fee is meant to remunerate the asset management company for managing the investor's money.
 - Trustee Fees: It is payable to the trustees for managing the trust.
 - Custodian Fees: It is paid by the fund to the custodian which is the organization which handles the possession of the securities invested in by the fund.
 - Registrar and Transfer Agents Charges: It is payable to the registrar and the transfer agents for handling the formalities related to the transfer of units and other related operations.
 - Broker/dealer remuneration, audit fees, cost of funds transfer, cost of providing a/c statements and cost of statutory advertisements.

Net Asset Value

The current value of your investment can be known from the Net Asset Value or the NAV. The NAV, in effect, measures the value of the net assets (gross assets less liabilities) per unit. Mathematically, the NAV is given by $\{(\text{Market Value of the Scheme's Investments}) + \text{Other Assets (including accrued interest)} + \text{Unamortized Issue Expenses (only in case of schemes launched on a load basis)} - (\text{All Liabilities except unit capital and reserves})\} / \text{number of units outstanding at the end of the day}$. All assets and liabilities are valued at the current prices.

Illustration

Mr. Gupta purchased mutual fund units worth Rs. 10,000 at an NAV of Rs. 10 per unit on February 1, 2004. The entry load on the mutual fund was 2%. On September 15, 2004, he sold all the units at an NAV of Rs 20. The exit load was 0.5%.

1. Calculation of Applicable NAV and No. of Units Purchased:

- (a) Amount of Investment = Rs. 10,000
- (b) Market NAV = Rs. 10
- (c) Entry Load = 2% = Rs. 0.20 (2% of 10)
- (d) Applicable NAV (Purchase Price) = (b) + (c) = Rs. 10.20
- (e) Actual Units purchased = (a) / (d) = 980.392 units

2. Calculation of NAV at the time of Sale

- (a) NAV at the time of Sale = Rs 20
- (b) Exit Load = 0.5% or Rs.0.10 (0.5% of 20)
- (c) Applicable NAV = (a) – (b) = Rs. 19.90

3. Returns/Growth on Mutual Funds

- (a) Applicable NAV at the time of Redemption = Rs. 19.90
- (b) Applicable NAV at the time of Purchase = Rs. 10.20
- (c) Growth/ Returns on Investment = $\{(a) - (b) / (b) * 100\} = 95.30 \%$

Types of Mutual Fund Schemes

An umpteen number of criteria can be used to classify mutual funds into various categories. We have listed below the most common criteria used to classify funds:

- **Primary Aim/Asset Class:** It classifies funds according to the asset class they invest in.
- **Secondary Aim/Investment Sector:** It segregates funds on the basis of the sub sector or the special focus area in which the fund's investments are concentrated.
- **Duration/Liquidity:** This basis uses the maturity time i.e. whether the funds have any specific maturity date or not as the determinant for classifying the funds.
- **Trading Strategy:** It classifies funds on the basis of frequency with which the portfolio is churned.
- **Investment Strategy:** It uses investment philosophy followed by the fund as the criterion for categorizing the funds.
- **Basis of Security Selection:** It classifies funds according to the criteria used by the fund to select securities for its portfolio.
- **Objective of Investment:** The funds are classified on the basis of the investment objective where objective reflects the purpose for which the investor is investing his money.
- **Costs/Loads charged:** The funds are classified on the basis of whether or not there is any load attached on the purchase or sale of the units.

- **Place of Origin:** The funds use the criterion of the place of incorporation of the fund as the determining criterion for categorization.

A wide variety of Mutual Fund schemes exist to fulfill various investment needs based on financial position, risk tolerance and return expectations. A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period.

An **open-ended fund or scheme** is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices which are declared on a daily basis. The key feature of open-ended schemes is liquidity.

A **close-ended fund or scheme** has a stipulated maturity period e.g. 5-7 years. The fund is open for subscription only during a specified period declared at the time of launch of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices.

A scheme can also be classified as **growth scheme, income scheme, or balanced scheme** considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

Systematic Investment Plan (SIP)

SIP is an investment option that is presently available only with mutual funds. SIP is a vehicle offered by mutual funds to help you save regularly. It is just like a recurring deposit with the post office or bank where you put in a small amount every month. The difference here is that the amount is invested in a mutual fund/deposit. The minimum amount to be invested can be as small as Rs 500 and the frequency of investment is usually monthly or quarterly. It makes you disciplined in your savings. Every month you are forced to keep aside a fixed amount. This could either be debited directly from your account or you could give the mutual fund post-dated cheques. The SIP option is available with all types of funds like equity or income.

Systematic Transfer Plan (STP)

The SIP is the best route to invest with regular cash flows. However the gains could be enhanced by opting for STP along with the SIP. STP allows investors to make periodic transfers from one fund to another and is best suited for investors who want to invest lump sum money in schemes with stable returns and ensure small exposure. STP gives investors the option of systematic transfer of fixed amounts/ capital appreciation on a periodic basis to another plan/scheme of the mutual fund. The STP facility can be used to transfer funds from one plan to another plan in the same scheme or to another scheme within the fund.

For example, if one has Rs. 50,000 to invest in equities, he can put the entire amount in a liquid plan and go for a monthly SIP of Rs 5,000 in an equity plan through a Systematic transfer. STPs, too, offer a choice between a fixed and an appreciation option. A fixed-option STP allows investors to sweep a fixed sum at periodic intervals into another fund. Appreciation STP is activated only when the capital appreciation on the investment crosses a limit the investor has set. STP of capital appreciation is available only under the growth plan and not under dividend plan.

Growth Funds/Equity Oriented Schemes aim to provide capital appreciation over medium to long-term. Such schemes normally invest a major part of their corpus in equities, hence have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and investors may choose an option depending on their preferences.

Income/Debt Oriented Funds aim to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments; hence are less risky as compared to equity schemes. These funds are not affected by fluctuations in equity markets. However, opportunities of capital appreciation are limited in such funds.

Balanced Funds provide growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These are appropriate for investors looking for moderate growth. They generally invest 40-60% in equity and debt instruments respectively. These funds are also affected by fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile as compared to pure equity funds.

Money Market/Liquid Funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, Government securities etc. Returns on these schemes are less volatile than returns on other schemes. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

Gilt Funds invest exclusively in Government securities. Government securities have no default risk. NAVs of these schemes fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

Index Funds replicate the portfolio of a particular index such as the BSE Sensex index, S&P NSE 50 Index (Nifty) etc. These schemes invest in the securities in the same weight-age as comprised by an index. NAVs of such schemes rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as "tracking error" in technical terms.

The funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. E.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc are called **Sector Specific Schemes**. The returns on these funds are dependent on the performance of the underlying sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and should exit at an appropriate time. They may also seek advice of an expert.

The funds/schemes which invest in securities of only those sectors/companies based on Themes [Emerging Business Themes like Export Competitiveness, Leadership, Valuation OR India Leadership Fund, Emerging STAR core and Satellite Fund] are called **Theme Specific Schemes**.

Tax Saving Schemes offer tax rebates to the investors under specific provisions of the Income Tax Act, 1961 as the Government offers tax incentives for investment in specified avenues. E.g. Equity Linked Savings Schemes (ELSS). **Pension Schemes** also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks are like any equity-oriented scheme. Mutual Funds with insurance benefits like UTI's Unit Linked Insurance Plan also carry Income tax benefit. Mutual Funds industry in India is constrained by law from offering full fledged pension plans on the lines of 401 K plans available in the USA.

Other Schemes

Mutual funds generally provide their investors an option to invest their money either in a growth scheme or a dividend scheme. Dividend schemes are further classified as dividend payout and dividend reinvestment schemes.

Dividend Payout Scheme

When a fund registers gain over a period of time, it may choose to retain these profits in the fund or it can declare a dividend. Under this option the dividend that a mutual fund scheme declares is paid out to the investor and the fund's NAV stands reduced to that extent. Since mutual fund dividend is nothing but the part payment of the investor's money back to him, its NAV deflates to the same extent as and when the fund pays dividend. That is the reason why the NAV of the dividend scheme is always lower when compared with the NAV of the growth scheme of the same fund.

Dividend Reinvestment Scheme

Under the reinvestment option, the Mutual Fund itself ploughs it back at source by allotting additional units in the scheme to the investor. The cash is automatically used by the fund's administrators to buy more fund units on behalf of the investors and transfer them to individual investors' accounts. Fund holders realize a capital gain upon the sale of their units in the fund, as in the dividend reinvestment option there will be more fund units than they started with. In the dividend re-investment option, the dividend is not paid to you. Instead, additional units are purchased at the revised NAV.

Growth Option Scheme

The growth option on a mutual fund means that an investor in the fund will not receive any dividends that may be paid out by the stocks in the mutual fund. Some shares pay regular dividends, but by selecting a growth option, the mutual fund holder is allowing the fund company to reinvest the money it would otherwise pay out to the investor in the form of a dividend. This money increases the net asset value (NAV) of the mutual fund.

The growth option is not a good choice for the investor who wishes to receive regular cash payouts from his/her investments. However, it is a way for the investor to maximize the fund's NAV and, upon sale of the mutual funds, realize a higher capital gain on the same number of shares he/she originally purchased. In this case, the fund holder does not receive more shares, but his/her shares of the fund increase in value. In the growth scheme, all profits made by the fund are ploughed back into the scheme. This causes the Net Asset Value to rise over time. Thus, the NAV of the growth option will always be higher than that of the dividend option as the money is going back into the scheme.

Example

Let us assume that you have invested Rs. 1,000 in a fund at an NAV of Rs 10 per unit. Therefore the total number of units held by you is 100. Let's suppose that the fund records an appreciation of Rs. 2 per unit in its portfolio and declares this as dividend (i.e. it declares a dividend of Rs. 2 per unit). Under the dividend option you will receive Rs. 200 as dividend ($\text{Rs } 2 * 100 \text{ units}$) and the value of your holdings will be around your investment cost i.e. Rs. 1000. In the dividend reinvestment option, the Rs. 2 per unit declared as dividend would be reinvested in the fund at the prevailing ex-dividend NAV, and you would be left with 120 units worth Rs. 10 each. Lastly under the growth option, the appreciation will be reflected in the fund's NAV, which will increase from Rs 10 to Rs 12. Thus the value of your holdings will be Rs. 1200 ($\text{Rs. } 12 \text{ per unit} * 100 \text{ units}$).

Mutual Funds – Advantages

- **Professional Management:** Professional fund managers in the relevant asset classes as per the investment objective invest the money contributed by the investors. Professional fund management brings in greater skill and experience to investing.
- **Lower Risk:** Mutual Funds invest the money in a large number of securities, and at times even over different asset classes within the same scheme. Investment in a large number of securities and different asset classes reduces the risk to which an ordinary person investing by himself might be exposed.
- **Better Portfolio for Less Money:** Since the investor buys a share in the assets of the fund, he gets a proportionate right over a large number of securities, which he would be unable to possess if he were to invest himself. For instance, Rs.5000 may not be enough to buy even one share of a top notch software company while the same Rs.5000 invested in an Information Technology Mutual Fund will get the investor a proportionate share in a large number of premium software scrips.
- **Lower Transaction Cost:** A mutual fund, by virtue of its status and the volume of the transactions it conducts is able to carry out buy and sell transactions more cost effectively.

Mutual Funds - Disadvantages

- **No Guarantees:** No investment is risk free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. However, investors encounter fewer risks when they invest in mutual funds than when they buy and sell stocks on their own.
- **No Control:** An investor has little or no control over the investments made by his fund. Funds therefore, to quote a fund manager, cannot be managed by "popular democracy". While this lack of control may be viewed as a disadvantage by one investor, another may see it as an advantage.
- **Fees and Commissions:** All funds charge administrative fees to cover their day-to-day expenses. Some funds also charge sales commissions or "loads" to compensate brokers, financial consultants, or financial planners. Even if you do not use a broker or financial adviser, you will pay a sales commission if you buy shares in a Load Fund.
- **Taxes:** During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If your fund makes a profit on its sales, you will pay taxes on the income you receive, even if you reinvest the money you made.
- **Management Risk:** When you invest in a mutual fund, you depend on the fund manager to make the right decision regarding the fund's portfolio. If the manager does not perform as well as you had hoped, you might not make as much money on your investment as you expected. Of course, if you invest in index funds, you forego management risk, because these funds do not employ managers.