



Mutual Funds a Good Investment Opportunity-An Inside View

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INTRODUCTION

In today time different investment avenues are available to investors & Mutual funds is one of them which also offer good investment opportunities to the investors. Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions. The investors may seek advice from experts and consultants including agents and distributors of mutual funds schemes while making investment decisions.

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 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. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed

basket of securities at a relatively low cost.

OBJECTIVES

- * To highlight the features of Mutual Funds investment.
- * To compare the performance of mutual funds with bank deposits and other underlying assets in the long term.

Definition of Mutual Fund

Mutual fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document.

Characteristics of Mutual Funds:-

Risk Tolerance: - Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions.

Managing Risk:- Mutual funds offer incredible flexibility in managing investment risk. Diversification and



Automatic Investing (SIP) are two key techniques you can use to reduce your investment risk considerably and reach your long-term financial goals.

Diversification:-When an investor invests in one mutual fund, you instantly spread your risk over a number of different companies. You can also diversify over several different kinds of securities by investing in different mutual funds, further reducing your potential risk.

Benefits of Mutual Funds

Professional investment management- Mutual funds hire full-time, high-level investment professionals. Funds can afford to do so as they manage large pools of money. The managers have real-time access to crucial market information and are able to execute trades on the largest and most cost-effective scale.

Diversification- Mutual funds invest in a broad range of securities. This limits investment risk by reducing the effect of a possible decline in the value of any one security. Mutual fund unit-holders can benefit from diversification techniques usually available only to investors wealthy enough to buy significant positions in a wide variety of securities.

Low Cost: -A mutual fund lets you participate in a diversified portfolio for as

little as Rs.5, 000/-, and sometimes less. And with a no-load fund, you pay little or no sales charges to own them.

Convenience and Flexibility -You own just one security rather than many, yet enjoy the benefits of a diversified portfolio and a wide range of services. Fund managers decide what securities to trade collect the interest payments and see that your dividends on portfolio securities are received and your rights exercised.

Personal Service-One call puts you in touch with a specialist who can provide you with information you can use to make your own investment choices. They will provide you personal assistance in buying and selling your fund units, provide fund information and answer questions about your account status.

Liquidity-In open-ended schemes, you can get your money back promptly at net asset value related prices from the mutual fund itself.

Transparency -You get regular information on the value of your investment in addition to disclosure on the specific investments made by the mutual fund scheme.

Disadvantages of Mutual Funds

No Control over Costs: - An investor in a mutual fund has no control over the overall cost of investing. He pays



investment management fees as long as he remains with the fund, albeit in return for the professional management and research.

No Tailor-made Portfolio:-Investors who invest on their own can build their own portfolios of shares, bonds and other securities. Investing through funds mean he delegates this decision to the fund managers.

Managing a Portfolio of Funds: Availability of a large number of funds can actually mean too much choice for the investor. He may again need advice on how to select a fund to achieve his objectives, quite similar to the situation when he has to select individual shares or bonds to invest in.

Money can be made from mutual funds in three ways:

* Income is earned from **dividends** on stocks and **interest** on bonds. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution.

* If the fund sells securities that have increased in price, the fund has a **capital gain**. Most funds also pass on these gains to investors in a distribution.

* If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit.

Basics of Mutual Funds

Different Plans under Offer: -In order to cater to the different investment needs of the investors, mutual funds offer various investment options.

Growth Plan: - Under growth option, dividend is not paid out to the investors and the investor realizes only the capital appreciation on the investment through the increase in the NAV.

Dividend Payout Option: - Under dividend payout option, dividends are paid out to investors. However the NAV of the mutual fund scheme falls to the extent of dividend payout.

Dividend Reinvestment Option: - In the dividend reinvestment option, the dividend accrued on the mutual funds is automatically reinvested in purchasing additional units in open ended funds. In general mutual funds offer to investors option to either collect the dividends or reinvest it.

Retirement Pension Option: - Some of the mutual funds offer schemes with retirement pension option. Individuals participate in these options for themselves, and Corporates participate for their employees.

Insurance Option: - Some mutual funds also offer schemes which provide



insurance cover to investors as an extra benefit.

Systematic Investment Plan (SIP): - Here the investor is given the option of preparing a pre-determined number of post-dated cheque in favour of the fund. The investor is allotted units on a predetermined date specified in the offer document at the applicable NAV.

Systematic withdrawal plan (SWP): - As opposed to the Systematic Investment Plan, the Systematic Encashment Plan allows the investor the facility to withdraw a predetermined amount / units from his fund at a pre-determined interval. The investor's units will be redeemed at the applicable NAV as on that day.

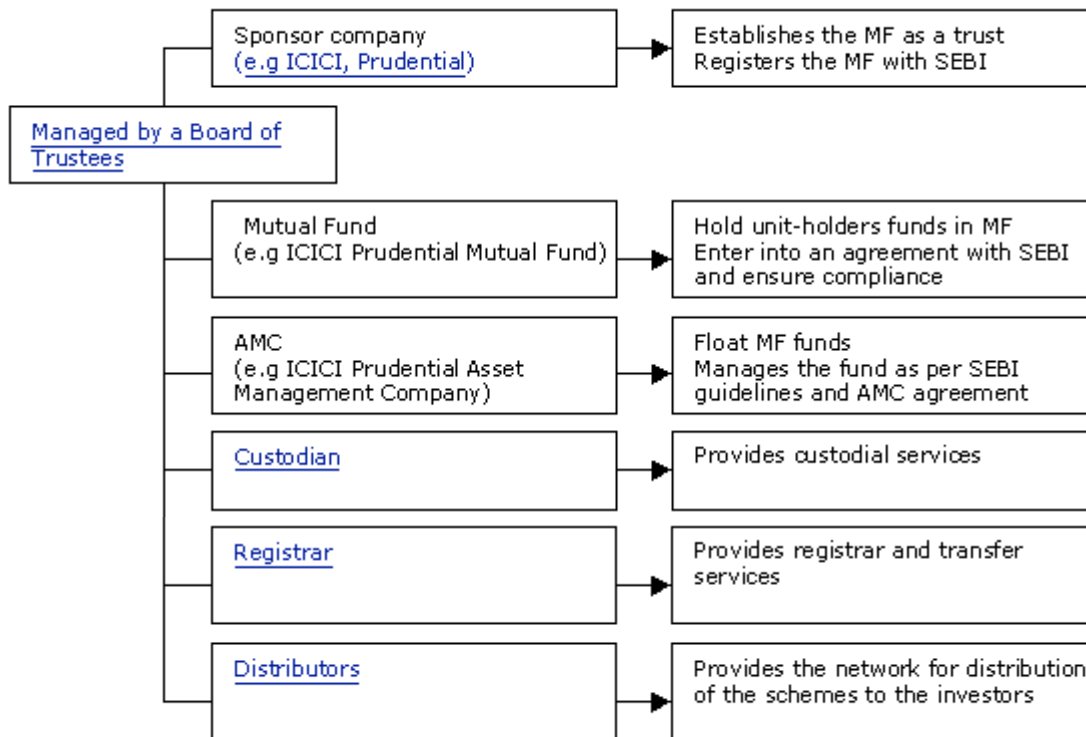
Constituents of Mutual Funds:-

Sponsor: - In the context of mutual funds, an underwriting company that offers shares in its mutual funds. An underwriter must sponsor a mutual fund issue for investors to have access to it.

Registrar: - The group is responsible for maintaining a list of all investors in the fund.

Custodian: - Custodian is an independent organization which takes custody of securities and other assets of mutual funds. Its responsibility includes receipt and delivery of securities and collecting income distributing dividends, safe keeping of the units and segregating assets and settlements between schemes. Their charge ranges between .15-0.2 percent of the net value of the holdings. Custodian can service more than one fund.

Trust/ board of trustees: - Trustees hold a fiduciary responsibility towards units holders by protecting their interest trustee's float and market schemes and secure necessary approvals. They checks if the investors get an annual report .AMC's investments are with in well defined limits, whether the fund's assets are protected and also ensure that units holders get their due returns.



History of Mutual funds in India:-

Mutual funds industry started in India with the formation of UTI in the year 1963. The development in mutual funds investments is divided in the following phases.

Phase 1:

- Establishment of UTI in 1963
- Launch of first scheme US-64
- Followed by ULIP in 1971, cggf (1986), Master share (1987).

Phase 2:

- Establishment of SBI-MF, the first non-UTI MF
- Followed by Canbanks MF, LIC MF, BOI MF
- UTI still dominating the market

Phase 3:

- Entry of the private sector fund in 1993



- Joint Venture of foreign fund management companies with Indian Promoters
- More competitive Product innovation, investment management techniques, investors servicing techniques

Phase 4:

- SEBI- the regulatory authority
- UTI came under SEBI regulation

Types of Mutual Funds:

	Scheme type		Time Horizon	Risk Profile	Typical Investment Pattern		
	Open	Close			Equity (%)	Debt (%)	Money Market Inst./Others (%)
Objective	Open	Close			Equity (%)	Debt (%)	Money Market Inst./Others (%)
Money Market	Yes	No	Short-Term	Low	0	0-20	80-100
Income	Yes	Yes	Medium-Long Term	Low to Medium	0	80-100	0-20
Growth	Yes	Yes	Long Term	High	80-100	0-20	0-20
Balanced	Yes	Yes	Long term	Medium to high	0-60	0-40	0-20
Tax Saving	Yes	Yes	Long term	High	80-100	80-100	0-20

By Structure:-

Open-ended fund scheme: - An open-ended fund scheme is one that 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.



Closed-ended Fund: - A closed-ended fund scheme has a stipulated maturity period e.g. 5-7 years. The fund is open for subscription only during a specified period 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. Some closed-ended funds also give an option of selling back the units to the mutual fund through periodic repurchase at NAV related price.

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

Growth/ Equity oriented scheme: - The aim of growth funds is to provide capital appreciation over the medium to long term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose depending on their preferences.

Income / Debt Oriented scheme: - The aim of income funds is 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. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country.

Balanced funds: - The aim of balanced is to provide both growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These schemes are appropriate for investors looking for moderate growth.

Money Market or Liquid Fund: - These 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 fluctuate much less compared to other funds.



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

Index funds: - Index Funds replicate the portfolio of a particular index such as the BSE Sensitive index, S&P NSE 50 index (Nifty), etc. These schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index.

Sector specific Funds: - These are the funds 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. The returns in these funds are dependents on the performance of the respective sectors/ industries. While these funds may give higher returns, they are more risky compared to diversified funds.

Tax Saving Schemes: - These schemes offers 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

launched by the mutual funds also offer tax benefits.

Performance Indicators

Valuation of a Fund (NAV)

The performance of a scheme is reflected in its net asset value (NAV) which is disclosed on daily basis in case of open-ended schemes and on weekly basis in case of close-ended schemes. The NAVs of mutual funds are required to be published in newspapers.

The NAVs are also available on the web sites of mutual funds. All mutual funds are also required to put their NAVs on the web site of Association of Mutual Funds in India (AMFI) www.amfiindia.com and thus the investors can access NAVs of all mutual funds at one place Mutual Funds invest the money collected from the investors in securities held by the scheme. Since market value of securities changes everyday, NAV of the schemes also varies with on the day-to-day basis. The NAV per unit is the market value of securities of a scheme divided by the total number of the scheme on any particular date.

$$\text{NAV} = \frac{\text{Receivable+ accrued income-liabilities}}{\text{Number of Shares or units outstanding}}$$



Asset allocation: The key to investment

In the process of personal financial planning an individual must select assets that will generate adequate returns to meet the financial goals, and at the desired levels of risk. This is known as asset allocation. Go through our Risk Analyser to learn what your asset allocation strategy should be.

Though "asset allocation" decisions are critical to one's financial plan, it is one that very few understand and consciously keep in mind when making an investment decision. There are two questions to be answered in every asset allocation decision: WHAT and HOW?

WHAT?

Asset allocation decision is about dividing the investments between asset classes such as equities, cash and money markets equivalents, bonds, insurance, real estate, derivatives. Commodities, antiques and art, international financial instruments.

HOW?

Once an individual has identified these asset classes, he/she needs to know how to divide his/her investments in these asset classes. The key considerations in choosing the asset classes are the level of return and the risk. Liquidity, transaction costs and ease of investment are the

other considerations. To keep it simple, some investors may prefer to look at it as balancing the downside (protection against capital loss) with upside (potential for high returns), which is not entirely correct but a useful way to look at investments. For instance, bank deposits may seem to provide a complete protection against capital loss. This is not true as in highly inflationary times, the deposits made at lower rates may not provide returns adequate to even beat inflation. This means that the capital value reduces in real terms even though in nominal terms that is not the case.

The factors that one should consider in choosing exposures to different asset classes are as follows:

Risk Tolerance: The degree to which one can tolerate risk varies for different people, and depends on the following:

Stage in life: A younger person, having a safe livelihood and few dependents, has time on his/her side can take more risk while choosing a portfolio.

Net-worth: If one owns lot of assets and have few liabilities i.e. have a high net worth one can afford to take more risk as one has a cushion of assets that can safeguard one from short-term losses occurring in due to market fluctuations.



Experience with investments: If one has prior experience in investing in financial markets and one is comfortable with short-term fluctuations then one can take more risk and hence more exposure to equity/real estate.

Investment objective: This entails deciding the purpose for which the investments are being made. Different objectives would demand that one tailor their investment portfolio to meet these goals.

Time Horizon: The time for which one would like to hold an investment also impacts the level of risk that one can undertake. If the goal for which the investment is being made is occurring after a long time, then one can pursue higher returns by investing in a more risky portfolio as over the period of time the risk reduces. However if one needs the money in the near future then one must invest in a safer portfolio

How to choose a Fund?

The first step to investing in Mutual Fund is to define the objective of investing. One should clearly lay down the purpose for which you desire to invest. There are several schemes tailor made to meet certain personal financial goals (children's education, marriage, retirement etc.) which can be availed of. Investors should define the tenure of investment and the risk appetite you

have. Thereafter, one can select a fund type that best meets your need i.e. income schemes, liquid schemes, tax saving schemes, equity schemes etc. There are lots of fund options available to investors and he can choose the particular fund that accomplishes his investment objectives.

Fund can be chosen on various criteria but primarily these can be the following:

- The track record of performance of schemes over the last few years managed by the fund
- Quality of management and administration
- Parentage of the Mutual Fund
- Quality and adequacy of disclosures
- Service levels
- The price at which you can enter/exit (i.e. entry load / exit load) the scheme and its impact on overall return
- The market price of the units of the scheme (where available) to see the discount/premium that the market assigns to the stated NAV of the scheme
- Independent rating of the schemes, if available

Investor could be investing in a mutual fund either at the initial stage when the mutual fund approaches the market through an offer document route or at a subsequent stage. If he chooses to invest



at the initial stage, the offer document would detail the schemes being offered and the manner of investing. The manner is usually similar to that of investing any public issue of any security (equity/debt).

Types of Risk involved in Mutual Fund Investment: -

All investments involve some form of risk. Consider these common types of risk and evaluate them against potential rewards when you select an investment.

Market Risks:-The time at which prices or yields of all the securities in a particular market rise or fall due to broad outside influences.

Inflation Risk:-This risk is sometimes referred to as "loss of purchasing power." Whenever inflation sprints forward faster than the earnings on your investment, you run the risk that you'll actually be able to buy less, not more.

Credit Risk:-In short, how stable is the company or entity to which you lend your money when you invest? How certain are you that it will be able to pay the interest you are promised, or repay your principal when the investment matures?

Interest Rate Risk:-Changing interest rates affect both equities and bonds in many ways. Investors are reminded that "predicting" which way rates will go is rarely successful. A diversified portfolio can help in offsetting these changes.

Exchange Risks:-A number of companies generate revenues in foreign

currencies and may have investments or expenses also denominated in foreign currencies. Changes in exchange rates may, therefore, have a positive or negative impact on companies which in turn would have an effect on the investment of the fund.

Investment Risk:-The sectoral fund schemes, investments will be predominantly in equities of select companies in the particular sectors. Accordingly, the NAV of the schemes are linked to the equity performance of such companies and may be more volatile than a more diversified portfolio of equities.

Changes in Government Policies:-Changes in Government policy especially in regard to the tax benefits may impact the business prospects of the companies leading to an impact on the investments made by the fund.

Commonly Used Terms in Mutual Funds Industry

Absolute Return: - The return that an asset achieves over a certain period of time Absolute return investment techniques include using short selling, futures, options, derivatives, arbitrage, leverage and unconventional assets.

Expense Ratio: - A measure of the total costs associated with managing and operating an investment fund such as a mutual fund. These costs consist



primarily of management fees and additional expenses such as trading fees, legal fees, auditor fees and other operational expenses. The total cost of the fund is divided by the fund's total assets to arrive at a percentage amount, which represents the TER:

$$\text{Total Expense Ratio} = \frac{\text{Total Fund Costs}}{\text{Total Fund Assets}}$$

Load or no-load Fund: - A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses.

/redemption price: -The price or NAV a unit holder is charged while investing in an open-ended scheme is called sales price. It may include sales load, if applicable. Repurchase or redemption price is the price or NAV at which an open-ended scheme purchases or redeems its units from the unit holders. It may include exit load, if applicable.

CDSC: Contingent Deferred Sales Charge imposed when the units are redeemed within the first four years of the unit ownership.

R-Squared: - R-squared values range from 0 to 100. An R-squared of 100 means that all movements of a security are completely explained by movements

in the index. A higher R-squared value will indicate a more useful beta figure. For example, if a fund has an R-squared value of close to 100, yet has a beta below 1, it is most likely offering higher risk-adjusted returns. A low R-squared means you should ignore the beta.

Alpha: - Alpha is one of five technical risk ratios; the others are beta, standard deviation, R-squared, and the Sharpe ratio. These are all statistical measurements used in Modern Portfolio Theory (MPT). All of these indicators are intended to help investors determine the risk-reward profile of a mutual fund. Simply stated, alpha is often considered to represent the value that a portfolio manager adds to or Subtract from a funds return

A positive alpha of 1.0 means the fund has outperformed its benchmark index by 1%. Correspondingly, a similar negative alpha would indicate underperformance of 1%

Beta: - Beta is calculated using regression analysis, and you can think of beta as the tendency of a security's returns to respond to swings in the market. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more



volatile than the market. For example, if a stock's beta is 1.2, it's theoretically 20% more volatile than the market.

CAPM- Model: - A model that describes the relationship between risk and expected return and that is used in the pricing of risky securities.

$$\bar{r}_a = r_f + \beta_a(\bar{r}_m - r_f)$$

Where:

r_f = Risk free rate

β_a = Beta of the security

\bar{r}_m = Expected market return

Mutual Funds Companies in India:

Below is the companies who offers different plans according to the requirements of the ultimate consumer :-

- ABN AMRO Mutual Fund
- Birla Sun Life Mutual Fund
- Bank of Baroda Mutual Fund
- HDFC Mutual Fund
- HSBC Mutual Fund
- ING Vysya Mutual Fund
- Prudential ICICI Mutual Fund
- State Bank of India Mutual Fund
- Kotak Mahindra Mutual Fund
- Unit Trust of India Mutual Fund
- Reliance Mutual Fund
- Standard Chartered Mutual Fund
- Franklin Templeton India Mutual Fund
- Morgan Stanley Mutual Fund India
- Alliance Capital Mutual Fund
- Canbank Mutual Fund
- Chola Mutual Fund

- LIC Mutual Fund
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- www.businessstandard.com
- www.rbi.org.com
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