FUNDAMENTALS OF MUTUAL FUNDS

Mutual Fund: A Concept

- A Mutual Fund is a collective investment vehicle that pools together investor money. This collective pool of money is invested in accordance to a stated objective
- Mutual Funds are :
  - ➢ A large pool of resources
  - ➢ Managed by professionals (AMCs)
  - ➢ Invested in a diverse portfolio
  - ➢ To optimize returns for a given level of risk

Mutual Fund terminologies

- Fund - Is a pool of assets (i.e. comprising debt and equity securities) invested in by fund manager of the mutual fund

- Unit - Represents a proportion of the portfolio of the fund

- Account Value
  - Value of units
  - Equal to Number of Units multiplied by NAV

Advantages of Investing in Mutual Funds over Direct Investments

- Portfolio Diversification
- Professional Management
- Reduction / Diversification of Risk
- Flexibility & Convenience
- Liquidity
- Reduction in Transaction cost
- Safety of regulated environment
- Return potential
- Other benefits

Disadvantages of Investing in Mutual Funds over Direct Investments

- Managing a Portfolio Funds
- Negligible control over Costs
- No Tailor-made Portfolios

Industry Profile

- Industry Structure
  - UTI
  - Public Sector MF's
  - Private Sector MFs
    - Indian Private Sector Funds
    - JV with Foreign Funds
    - Foreign MFs

Types of Mutual Fund

Mutual Funds can be classified as:

- Open ended / Close-ended Funds
- Load Fund / No-Load Funds
- Tax-exempt / Non-Tax exempt Funds

Open Ended Funds

- Open Ended Fund:
  - Units available for sale / purchase at all times at NAV based prices
  - Fresh subscriptions may be discontinued
  - Unit Capital is variable
  - Any time redemptions always allowed, except when there is lock in period

Close Ended Funds

- Close Ended Fund:
  - Initial Public Offer
  - Investor cannot buy units later on from MF
  - Unit Capital Constant
  - Redemption of Units on expiry date
  - Traded on Stock exchange at a discount to NAV
  - Get listed on the Stock Exchange
  - Close ended funds may allow buy back of units option

Load

- Margin added to or deducted from the Net Asset Value of the unit when units are sold or bought from the investors
- **Entry Load**: Margin added to NAV at the time of investment

  (Normally applied to those funds where equity forms > 50% of assets, and ranges from 2 – 2.50%)
- **Exit Load:** Margin deducted from the NAV at the time of redemption

  (Normally applied to those funds where equity forms < 50% of assets, and ranges from 0.25 – 0.50%)

Load Funds

- Load is one time fee payable by the investor when they enter / exit an open-ended scheme.
- Loads are charged to recover initial issue expenses including marketing & selling expenses, brokerage, advertising costs
- There can be Entry load or Exit load or both
- Entry load is also called Front-end load
- Exit load is also called Back-end load or Deferred load
- Since 2010, Entry load for mutual funds in India has been removed (0%)

No Load Funds & Impact of Loads

- In a No load fund, marketing and selling expenses are absorbed by the AMC and the investor buys and sells units at NAV price
- Return on investment to the investor is reduced because of the loads
  - When the investor buys a unit from the MFs, he pays more than NAV (NAV + entry load)
  - When the investor sells the unit to the MF, he gets less than NAV (NAV – exit load)

Example on Loads and Returns

Date	Action	NAV (Rs)	Entry Load	Exit Load
1 – Jan	Entry	11.00	2%	-
31 – Dec	Exit	12.00	-	1%

<u>ROI with Loads</u>

Amount invested = 11 + 0.22 = 11.22 Rs.

Amount received = 12 – 0.12 = 11.88 Rs.

Gain = 0.66 Rs.

ROI = (0.66 x 100) /11.22 = 5.88%

Example on Loads and Returns

ROI without loads

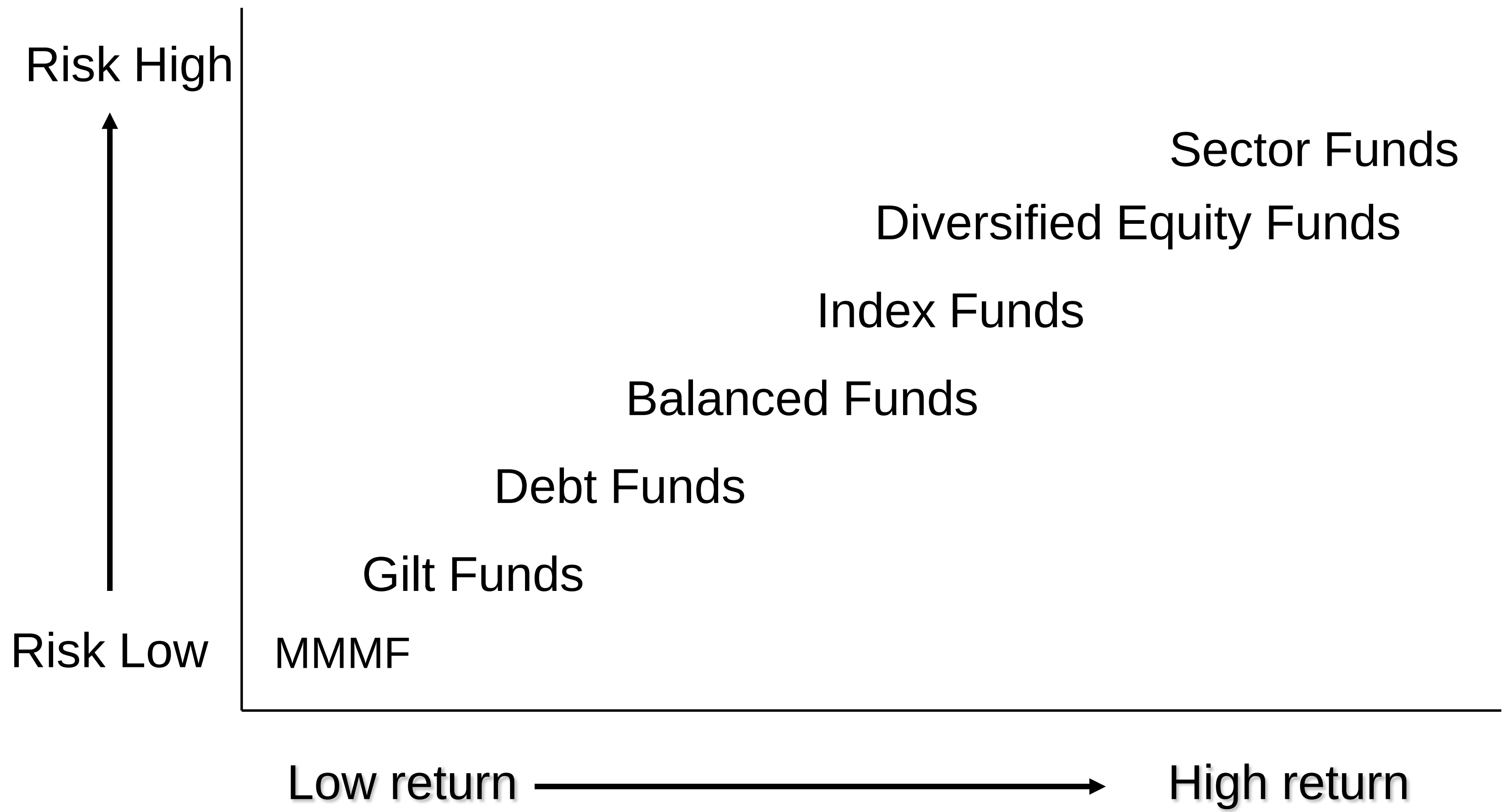
Amount invested = 11 Rs.

Amount received = 12 Rs.

Gain = 1 Rs.

ROI=(1 x 100) /11 = 9.09%

Risk-Return Hierarchy of Different Funds



Money Market Funds

- Invests in securities of less than 360 days maturity
- Low risk and low returns
- High liquidity & **safety of principal**

Gilt Funds

- Invests only in Government Securities of over 1 year maturity
- Risk and return low but higher than that of MMF (Money Market Fund)
- Fund values drops when interest rates go up & rise when interest rates go down
- Negligible Default Risk but carries Interest rate risk

Debt Funds

- Invest in Corporate Bonds and Government Securities
- Risk higher in comparison to Gilt Funds
- Aims at regular Income Distribution
- Capital Appreciation is a secondary objective

Types of Debt Funds

- **Diversified Debt Funds:** Debt funds that invest in all securities issued by entities belonging to all sectors of the market are known as diversified debt funds
- **Fixed Term Plan Series:** Fixed Term Plan Series usually are closed-end schemes having short term maturity period (of less than one year) that offer a series of plans and issue units to investors at regular intervals
- **High Yield Debt:** Funds prefer securities issued by those issuers who are considered to be of "below investment grade". The motive behind adopting this sort of risky strategy is to earn higher interest returns from these issuers. These funds are more volatile and bear higher default risk, although they may earn at times higher returns for investors
- **Assured Return Funds:** Although it is not necessary that a fund will meet its objectives or provide assured returns to investors, but there can be funds that come with a lock-in period and offer assurance of annual returns to investors during the lock-in period. Any shortfall in returns is suffered by the sponsors or the Asset Management Companies (AMCs)

Equity Funds

- Invests in Equity and Equity related instruments only
- High risk
- Objective is Capital Appreciation

Equity Funds & Types

- **Diversified Equity Funds:** Diversified equity fund diversifies its investment across the market which reduces the risk of the entire portfolio
- **Equity Index Funds:** An equity index fund is a type of mutual fund that tracks the performance of a particular stock index. Some of the indexes commonly followed include the SENSEX and NIFTY
- **ELSS Funds:** Equity Linked Saving Scheme (ELSS) is a kind of equity mutual fund which makes its investments in equity and related instruments. But there are certain features of ELSS which differentiates it from other equity mutual funds
- **Equity Income or Dividend Yield Fund:** Equity income or dividend yield fund is a fund that offers dividend payout based on the dividends that are paid out by the companies included in the fund

Types of Hybrid Funds

- Balanced Funds: Seek to provide regular income & Capital appreciation
- Growth & Income Funds: Seek to provide High dividend and Capital appreciation
- Asset Allocation Funds: Flexible asset allocation between Debt, Equity & MM

Other Funds

- Commodity Funds :Invest in commodity stocks
- Real Estate Funds :Invest in stocks of real estate companies
- Exchange Traded Funds :Trade like a single stock on the stock exchange
- Fund of Funds :Invest in other Mutual Fund Schemes

Systematic Investment Plan

- S-I-P allows the investor to invest a fixed sum every month by purchasing additional units at that prevailing price
- Based on the principal of “Rupee Cost Averaging”
- Allows you to buy more when price is low and buy less when price is high
- Loves volatility : uses volatility to its advantage
- Operationally the most convenient to implement

Rupee Cost Averaging

- RCA uses volatility to its advantage: Rs 1,000 Systematic Investment per month

Month	Lower Volatility Case		Higher Volatility Case	
	Price	No. of units	Price	No. of units
Jan	10	100	10	100
Feb	8	125	7	143
Mar	6	167	5	200
Apr	8	125	9	111
May	10	100	11	91
Jun	12	83	13	77
Jul	10	100	9	111
Aug	8	125	7	143
Sep	6	167	5	200
Oct	6	167	5	200
Nov	8	125	9	111
Dec	10	100	10	100
Total units purchased	**1,484**		**1,587**	
Average cost per unit	**8.09**		**7.56**	