BASICS OF MUTUAL FUNDS

Mutual Funds are an alternative investment avenue that an investor can consider as they help you grow wealth over a period of time.

Mutual funds have gained popularity in recent past as an attractive asset class. This is mainly on account of limited investment opportunities and financialization of savings. Also, bank fixed deposits, gold and real estate have started losing their shine as they no longer provide attractive returns as those offered by mutual funds thanks to the bull run in the equity markets.

Mutual fund houses provide a gamut of schemes, which enables an investor to invest as per his/her risk appetite – be it debt funds, equity funds, balanced funds. Index funds, capital protection oriented funds or commodity funds.

This brings us to the moot question, what are mutual funds?

Mutual fund is a trust that is professionally managed by

investment managers, also termed as fund managers. They pool the savings of a plethora of investors and then invest those savings in securities like bonds, stocks, money market instruments and commodities such as precious metals.

The investment is made in accordance with the objective of the fund/scheme, which is predefined. Thus, investors with a common financial goal will invest in a particular fund/scheme.

Therefore, if investors choose to invest in a banking sector scheme, investment managers will invest in banking sector stocks. If an investor decides to invest in a balanced scheme, the investment manager will invest in a blend of equity and debt in the proportion spelt out in the scheme's investment objective.

One of the principal benefits that mutual funds bring to the table is that mutual funds enable retail investors to have a professional manage their investments even if their contribution is as low as a thousand rupees. Active management of mutual funds is best left to professionals who understand the asset classes well rather than laymen who often tend to get influenced by hearsay.

In order to achieve your investment goals, it is essential to select the right mutual fund scheme and without any exaggeration the choice is overwhelming. Currently, there are 45 fund houses, 1,200 schemes on offer.

Of these approximately 400 are equity funds, around 300 are debt schemes and around 426 are hybrid schemes. In addition to this, there are more than 800 FMPs (Fixed Maturity Plans), some international funds, arbitrage funds, etc.

Mutual fund schemes can belong to different asset classes and have varied structures with different investment objectives. For example, within equity schemes itself you will have several choices - large-cap funds, mid-cap funds, flexi-cap funds, index funds and sector-specific funds, among others. In debt, you have monthly income plans (MIPs), short-term plans, long-term plans, gilt funds, etc.

It is, therefore, essential to have an understanding of the different types of schemes that are on offer to decide, which type to invest in.

After filtering the type, it makes it easier to zero in on a particular scheme based on performance. Broadly, mutual fund schemes can be classified based on maturity, asset class and the investment objective.

Let us delve into each of this to get a better understating of the different investment options.

PROFILING BASED ON MATURITY

Open-Ended Scheme

Open-ended schemes are the most commonly prevailing schemes. Here, subscription and redemption are permitted on an on-going basis. Investors can enter and exit the scheme at any point in time at the applicable NAV.

Liquidity is the primary benefit, which makes open-ended schemes an attractive proposition from the point of view that as funds are accessible with a lead time of a day.

Close-Ended Scheme

A close-ended scheme is one where the maturity is pre-defined. For example, a two-year or a three-year product. These schemes are open for subscription for a limited time frame at the time of launch. These are listed on stock exchanges. For example, Fixed Maturity Plans (FMPs).

Interval Schemes

Interval schemes are a blend of both open and close-ended funds. These are open for subscription or redemption at predetermined intervals at the prevailing NAV. For example, DSP Blackrock Micro-cap Fund, a pure play equity mutual fund, closed for subscription after reaching a sizable AUM.

PROFILING BASED ON ASSET CLASS

Equity Funds

Equity fund schemes are those that invest in the equity markets. Capital appreciation is a primary objective over the medium- to long-term. On account of being linked to the stock markets, which tends to be volatile, these funds are defined as high-risk investments (the extent of risk can vary depending on whether you invest in mid-cap or large-cap or sector-specific schemes).

Only those who have a risk appetite with the ability to hold the investment over the medium- to long-term should consider this asset class.

Debt Fund/ Fixed Income Funds

Funds that invest in rated fixed income securities such as corporate bonds, debentures, government securities, commercial papers and other money market instruments fall under the category of debt fund or fixed income funds.

These debt/fixed income funds are mainly targeted at investors who are risk-averse and are seeking regular and steady income.

Balanced Or Hybrid Funds

Balanced or hybrid funds are blended funds, which invest in a mix of asset classes. The objective is to reduce the risk of a pure equity fund as generally returns on bond and equities are inversely proportional.

For example, HDFC Prudence is a balanced mutual fund scheme with an investment objective of varying debt-equity mix between 25:75 and 40:60, respectively depending on the prevailing market conditions.

PROFILING BASED ON INVESTMENT FOCUS

Under equity mutual funds, there are several funds, which can be differentiated based on the focus.

Index Funds

These funds are passive funds and the goal of these funds is to mirror the performance of the benchmark/index it tracks such as CNX Nifty Index (example, HDFC Index-Nifty Plan). Thus, the value of the fund varies in proportion to the movement in the benchmark index. There may be a slight variation in returns from the benchmark on account of tracking error (example, new additions/ deletions from the index).

Diversified Funds

Diversified mutual funds provide investors with the benefit of diversification by investing in companies spread across sectors and market capitalization (example, mid-cap funds, large-cap funds, etc).

They are generally meant for investors who do not want the performance of their investments to be impacted by underperformance or outperformance of a particular sector or a particular category of stocks.

Sector Funds

Sector funds invest primarily in a particular identified sector such as pharma, banking and consumer durables, among others (example, Reliance Pharma Sector Fund). They tend to be risky as the risk is concentrated on the performance of one particular sector, which may be impacted by cyclicality or regulation or any other eventuality.

Tax-Saving Funds (ELSS)

Tax-saving funds are equity-oriented funds that qualify for deduction under the Income Tax Act (example, L&T Tax Advantage Fund). These funds typically have a lock-in period of 3 years in order to qualify for tax saving. The funds' returns are linked to the equity markets and, hence, are considered to be risky.

Exchange-Traded Funds (ETFs)

As the name suggests, exchange-traded funds track an index, a commodity or a basket of assets as closely as possible, and trade like shares on the stock exchanges (example, Kotak Banking ETF).

These funds are backed by physical holdings of the commodity, and invest in stocks of companies. By virtue of being listed on the stock exchanges, these mutual funds give the investor the flexibility to buy or sell on the stock exchanges.

International Funds

For those investors who prefer to have an exposure to companies located in other countries, these funds are preferred by them (Example, Franklin Asian Equity Fund). So there could be emerging market funds wherein the fund objective describes the markets they are permitted to invest in.

Debt Funds Would Include The Following Funds

Gilt Funds

Gilt funds invest in Central and State Government Securities and are best suited for medium- to long-term investors who are risk-averse (example, SBI Benchmark G-Sec Fund). Government Securities have no default risk. However, they are vulnerable to interest rate risks and the NAV gets impacted with any change in interest rates.

Liquid Funds/ Money Market Funds

These funds are meant for investors who want to park their surplus funds for a very short term such as a few days (example, Edelweiss Liquid Fund). The objective of this fund is capital preservation. The fund invests in securities with less than 91 days maturity. On redemption, the funds get credited within 24 hours making it extremely liquid.

Monthly Income Plans (MIPs)

As indicated by the nomenclature, MIPs are expected to be a regular income stream for investors (monthly, quarterly or half yearly dividend payouts). The fund invests in debt instruments like government bonds and corporate bonds, which offer dividends or interest payments.

In addition, in most cases 15% to 25% of the corpus is invested in equities. The equity portion is expected to provide an edge over pure play debt funds by providing superior returns.

Long-term Debt Funds

Debt funds are best chosen based on the investment tenure. A long-term bond fund is suited for investors with a 3- to 5-year time horizon. Long-term bond funds invest in a mix

of corporate bonds and government securities with a tenure of 7 and 10 years. Long-term bond funds are meant to give you returns in excess of bank fixed deposits.

Short-term Debt Funds

Short-term debt funds are suitable for investors who have an investment horizon of between 12 and 36 months. The returns are superior as compared to gilt funds and liquid funds. There are also sub-categories under this called ultra-short term funds, which invests in instruments having a maturity of 90 days to 1.5 years and are less volatile.

Types Of Close Ended Schemes

Capital Protection Funds

Capital protection funds tend to be close-ended mutual fund schemes, which are hybrid in nature - skewed towards debt. The objective is to safeguard the capital and simultaneously provide capital appreciation. These funds provide even the most conservative investor an opportunity to invest a small part of his/her portfolio in equity, thereby giving the investor the scope to participate in equity market upturns.

Fixed Maturity Funds (FMPs)

Fixed maturity funds are close-ended mutual funds having a tenure of 3 to 5 years. These funds invest in debt and money market instruments where the maturity date is either the same as that of the fund or prior to it. FMPs are for those investors who would like to invest their funds for a fixed tenure and for those who do not want to take risks, especially when the interest rate trend is uncertain.

RECENT DEVELOPMENTS

To make it easier for investors to select the right mutual fund, markets regulator Securities and Exchange Board of India (SEBI) has initiated a move encouraging mutual fund companies to merge schemes with similar attributes bringing in some standardization.

There is a plethora of schemes, which makes it hard for investors to decide which scheme to invest in. It is currently in the early stages with the SEBI asking mutual fund companies to chalk out a plan. This new development will make it easier for investors to make informed decisions.

IN A NUTSHELL

Mutual fund houses provide us with a gamut of products satisfying the entire risk return spectrum, that is, from low risk low return to high risk high return. Investors need to understand their risk profile to zero in on first the asset class that will suit their need and then the type of scheme. It gives them an exposure to alternative asset classes and, hence, it deserves serious consideration given the inherent benefits it has to offe**R.**