B.D. SHAH SECURITIES LTD.
TO HELP YOUR MONEY MAKE MORE MONEY

MF Basics

Q. What is a Mutual Fund?

Ans. Mutual funds provide a way for investors to "mutually" share the benefits of investing. A mutual fund is an investment company that professionally invests a pool of money on behalf of individuals and institutions with similar investment goals by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document.

Investors of mutual funds are known as unit holders. Mutual fund issues units to the investors in accordance with quantum of money invested by them. The profits or losses are shared by the investors in proportion to their investments.

Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time.

Different Types of Mutual Funds

A wide variety of Mutual fund schemes cater to different preferences of the investors based on their financial position, risk tolerance and return expectations. The mutual fund schemes can be broadly categorized under 3 headings:

- Funds by Structure/ Maturity Period
- Funds by Investment objective
- Other Schemes

Funds by Structure/ Maturity Period: These include open ended and close ended schemes.

- An open ended fund provides the investors with an easy entry and exit option at NAV (Net Asset Value), which is declared on a daily basis. The key feature of these schemes is liquidity.

- A close-ended fund 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. 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. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

Funds by Investment Objective: 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:

- Growth/ Equity Oriented Schemes provide capital appreciation over medium to long – term by investing 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 an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

- Income/ Debt Oriented Schemes provide regular and steady income to investors by investing in fixed income securities such as bonds, corporate debentures, government securities and money market instruments. Hence they 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. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations.

- Balanced Funds 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 are appropriate for investors looking for moderate growth. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

- Money Market or Liquid Funds provide easy liquidity and preserve capital but generate moderate income. As they invest exclusively in safer short- term instruments such as treasury bills, certificates of deposit, commercial paper, inter bank call money and government securities. 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 also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

Other Schemes: These include index schemes, sector specific schemes, tax saving schemes and fund of funds schemes.

- 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 weight age as in the index. NAVs of such schemes would 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. There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges.

- Sector specific Funds/ Schemes 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 dependent on the performance of the respective 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 must exit at an appropriate time. They may also seek advice of an expert.

- 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 launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

- Fund of Funds (FoF) scheme invests primarily in other schemes of the same mutual fund or other mutual funds. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

Q. Why invest in Mutual Funds?

Ans. Mutual funds are popular investments, primarily because of their numerous benefits:

- **Diversification**: Mutual funds help you diversify your portfolio, or spread your money over a number of different investments that are handpicked and tracked by professional money managers. This strategy can help decrease risk to your portfolio because when your investment return isn't dependent on any single investment, the impact of one poor performer on your portfolio is reduced.

- **Convenience:** Mutual funds make investing easy and flexible by emphasizing convenience to the investor in several ways:

  - Low minimum investment: Most mutual funds require low minimum investments making it easy for investors to build a diverse portfolio fairly quickly.
  - Easy liquidity: You can cash in any or all of your mutual fund shares on any business day. The value of your shares is based on the closing market price (net asset value, or NAV) of the underlying securities.
  - Automatic reinvestment: You can automatically purchase more mutual fund shares by reinvesting your dividends and capital gains distributions.
  - Systematic withdrawal: You can request that regular payments from systematically selling shares be sent directly to you.

- **Professional Management:** Experienced, full-time money managers manage each mutual fund. These professional money managers:

  - Research general market and economic trends. Using the information they gather, the fund's professional money managers decide when to buy or sell securities to increase return potential and keep constant tabs on individual holdings and the overall performance of particular markets, adjusting the portfolio for the strongest possible performance.
  - Strive to achieve specific objectives: Because each fund has a specific investment objective, such as long-term growth or aggressive growth, managers can focus on the strategic goals of their funds.

- **Financial benefits:** These include:

  - Mutual fund unit holders can earn dividends on their mutual fund units.
  - Unit holders can also profit from the sale of their units if they sell them for more than their original value.*
  - Unit holders can receive their dividend payments directly or reinvest them back into the fund and purchase additional units.

(*An investment in mutual funds will fluctuate such that an investor's shares when redeemed may be worth more or less than the original investment)

Systematic Investment Plans

Investing regularly through a Systematic Investment Plan (SIP) in an equity fund is one strategy that can ensure success to a large extent for those who are looking to build up their capital over the longer term and are not familiar with equity markets. It is a proven fact that a steady saving and investing plan helps pursue financial goals. What SIP really means is that you invest a fixed sum every month. When you invest a fixed amount, such as Rs.10000 a month, you

Some of the <u>Benefits of SIPs</u> are as follows:

- **Rupee Cost Averaging** - SIP makes market timing irrelevant. In other words, you can invest a certain amount of money every month at various entry prices buying fewer units when the share prices are high and more units when the share prices are low. Besides, you take advantage of the fact that over a period of time stock markets generally go up, so your average cost price tends to fall below the average NAV. This "averaging" ensures that you buy at different levels, not just the top.
- **Benefit of Compounding** - The profits you earn from your investments get reinvested. Therefore you earn returns on your primary investments and reinvested profits.
- **Cost Effective Method of Investment** - Instead of blocking your money by making a one-time investment, in an SIP, you can spread the same amount over a certain period of time and maintain liquidity.
- **Building for the Future** - SIP is an effective method of ensuring regular savings and achieving your short-term or long-term financial goals. It is also an excellent method of utilizing your funds, which may be, otherwise, lying idle.

<u>Step-wise Approach to an SIP</u>

- Choose the amount you want to invest at each interval. (The amount must be such that you will be comfortable investing regularly over the long term)
- Choose the frequency of your investment - every month, every quarter, every six months.
- Continue investing the same amount each period irrespective of whether the market falls or rises.
- Maintain a long-term perspective. Ignore the day-to-day fluctuations in the market. Keep investing over a long period of time to give your money a chance to grow.

Significance of Mutual Fund Offer Document

There is no doubt that reading a 100-odd pages Mutual Fund Offer Document is a cumbersome and time-consuming process. However, the importance of this document for any potential investor should not be undermined at any point of time. The significance of the Offer Document is emphasized by the line "Mutual Fund investments are subject to market risks. Please read the offer document carefully before investing", which accompanies all Mutual Fund advertisements. Thankfully, Sebi has made the investor's job easier by evolving an abridged version, the Key Information Memorandum.

Q. What is a Mutual Fund Offer Document?

Ans. The Mutual Fund Offer Document is the fund's selling document and contains valuable information, such as the fund's investment objectives or goals, principal strategies for achieving those goals, principal risks of investing in the fund, fees and expenses, and past performance. The prospectus also identifies the fund's managers and advisers and describes how to purchase and redeem fund shares. This document can be obtained from fund companies directly, through mail, email, phone or from their websites or from a financial advisor.

While they may seem daunting at first, mutual fund prospectuses contain a treasure trove of valuable information. Here's some of what you'll find in a mutual fund prospectus:

- **Date of Issue:** It is mandatory for mutual funds to update their prospectus at least once a year. You must always ensure that you have received the most recent version of the same.

- **Minimum investments:** Check the minimum initial investment and minimum amount for subsequent investments specified in the Offer Document, since these vary from one fund to another.

- **Investment Objectives:** The Offer Document specifies the investment objectives of the fund, whether it is a growth-oriented, income-oriented or balanced fund. You need to decide whether your personal investment goal is long term capital appreciation with a higher risk exposure or a lower risk, regular income flow. Only if your investment objective matches with that of the fund, should you invest in it.

- **Investment Strategy:** The general investment strategies (equity/debt) that the fund managers intend to adopt to achieve the pre-specified goals, are outlined in the Offer Document. Minimum bond ratings and types of companies considered appropriate for a fund, may also be mentioned.

- **Risk Profile:** Do not be under the misconception that mutual funds are free from risk. While risks vary depending on the fund, the potential danger is the same - loss of principal and income. You must determine your own risk tolerance level based on your investment goals. Risks that may be acceptable for a long-term investor seeking capital appreciation may not be suitable for an investor seeking income and principal protection. It is essential for you to refer to the Offer Document to understand the various kinds of risks (eg. credit risk, market risk, interest-rate risk etc.) associated with the fund and how they fit into the balance of risk in your overall portfolio.

- **Financial Highlights:** This section contains audited data concerning the fund's financial performance for different time periods since the fund's inception. Here you'll find net asset values (for both the beginning and end of each period), total returns, and various ratios, including the ratio of expenses to average net assets, the ratio of net income to average net assets, and the portfolio turnover rate. Such performance data listed in an Offer Document are based on standard formulas established by Sebi and enable investors to make comparisons with other funds.

- While past performance does not necessarily predict future returns, it can tell you how volatile (or stable) a fund has been over a period of time. Generally, the more volatile a fund, the higher the investment risk. If you'll need your money to meet a financial goal in the near-term, you probably can't afford the risk of investing in a fund with a volatile history because you will not have enough time to ride out any declines in the stock market. So, you must read the historical performance of the fund critically, looking at both the long and short-term performance. When evaluating performance, you must look at the track record of a fund over a time period that matches your own investment goals.

- **Fees and Expenses Structure**: As with any business, running a mutual fund involves costs — including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses (eg. Entry loads, exit loads, switching charges, annual recurring expenses, management fees, investor servicing costs). The Offer Document lists the limits on these fees and also shows the impact these have had on the fund investment historically. Be sure to review carefully the fee tables of any funds you are considering. Even small differences in fees can translate into large differences in returns over time.

- **Tax Benefits:** The offer document gives the tax benefits enjoyed by the fund. This can help you plan your taxes better and help you enhance your post tax returns.

- **Fund Managers & other Key Personnel: The offer document gives** details on the education and work experience of the key management of the fund company, including the CEO and the Fund Managers.

- **Additional Investor Services:** This section describes any specific services which the investors can enjoy, such as automatic reinvestment of dividends and systematic investment/withdrawal plans and how one can take advantage of them.

All the information mentioned above will help you get a fair idea of the mode of functioning of the fund, and enable you to take the crucial decision – Is this fund suitable for my portfolio?