1. INTRODUCTION

Mutual Fund is a trust that pools together the resources of investors to make a foray into investments in the capital market thereby making the investor to be a part owner of the assets of the mutual fund. The fund is managed by a professional money manager who invests the money collected from different investors in various stocks, bonds or other securities according to specific investment objectives as established by the fund. If the value of the mutual fund investments goes up, the return on them increases and vice versa. The net income earned on the funds, along with capital appreciation of the investment, is shared amongst the unit holders in proportion to the units owned by them. Mutual Fund is therefore an indirect vehicle for the investor investing in capital markets. In return for administering the fund and managing its investment portfolio, the fund manager charges fees based on the value of the fund’s assets.
1.1 **Mutual Benefits**

Investing in mutual funds is an expert’s job in the present market scenario. A systematic investment in this instrument is bound to give rich dividends in the long-term. That is why over 2 crore investors have faith in mutual funds.

1.2 **What is a Mutual Fund**

A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. A mutual fund is the most suitable investment for the cautious investor as it offers an opportunity to invest in a diversified professionally managed basket of securities at a relatively low cost. So, we can say that Mutual Funds are trusts which pool resources from large number of investors through issue of units for investments in capital market instruments such as shares, debentures and bonds and money-market instruments such as commercial papers, certificate of deposits and treasury bonds.

1.3 **Who can invest in Mutual Funds**

Anybody with an investible surplus of as little as a few thousand rupees can invest in mutual funds by buying units of a particular mutual fund scheme that has a defined investment objective and strategy.

1.4 **How Mutual Funds work for you**

The money collected from the investors is invested by a fund manager in different types of securities. These could range from shares and debentures to money market instruments depending upon the scheme’s stated objectives.

The income earned through these investments and capital appreciation realized by the scheme is shared by its unit holders in proportion to the units owned by them. (please refer the diagram above)

1.5 **Should we invest in Stocks or Mutual Funds?**

As soon as, you have set your goals and decided to invest in equity the question arises should you invest in stocks or mutual funds? Well, you need to decide what kind of an investor you are.

First, consider if you have the kind of disposable income to invest in 15-20 stocks. That is how many stocks you will have to invest in if you want to create a well-diversified portfolio. Remember the
familiar adage: Do not put all your eggs in one basket? If ₹ 5,000 were all you have to spare, it would be impractical to invest it across many stocks.

Many beginners tend to focus on stocks that have a market price of less than ₹ 100 or ₹ 50; that should never be a criterion for choosing a stock. Also, brokerage could eat into your returns if you purchase small quantities of a stock.

On the other hand, you would be able to gain access to a wide basket of stocks for ₹ 5,000 if you buy into a fund. Investing in funds would also be an easy way to build your equity portfolio over time.

Let's say you can afford to put away only ₹ 1,000 a month in the market. You can simply invest in a fund every month through a systematic investment plan (SIP) as a matter of financial discipline. You can save yourself the trouble of scouting for a stock every month.

That brings us to the next point. Do you have the time to pick stocks? You need to invest a considerable amount of time reading newspapers, magazines, annual reports, quarterly updates, industry reports and talking to people who are familiar with industry practices. Else, you certainly won't catch a trend or pick a stock ahead of the market. How many great investors have you heard of who have not made investing their full-time job?

Plus, you may have the time, but not the inclination. You have to be an active investor, which means continuously monitor the stocks you pick and make changes – buy more, cut exposures – depending upon the turn of events. These actions have costs as well. As you churn your portfolio, you bear expenses such as capital gains tax. Funds do not pay capital gains tax when they sell a stock.

All this assumes you know what you are doing and have the skill to pick the right stocks. You are likely to be better at investing in an industry you understand. Only, too bad if that industry appears to be out of favour in the market.

If you love the thrill of the ups and downs in the stock market; if you find yourself turning to business channels and business newspapers hoping that you can pick the next Infosys; if you have an instinct for spotting stocks and, importantly, the discipline to act on it; if you have the emotional maturity to cut your losses when you are ahead, then you can trust yourself to invest in stocks.

Otherwise, hand over your money to the professional. Mutual funds could be the best avenue for the risk-averse Investors.

2. EVOLUTION OF THE INDIAN MUTUAL FUND INDUSTRY

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank of India. The history of mutual funds in India can be broadly divided into four distinct phases.

First Phase – 1964-87

Unit Trust of India (UTI) was established in 1963 by an Act of Parliament. It was set up by the
Reserve Bank of India and functioned under the regulatory and administrative control of the Reserve Bank of India. In 1978, UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988, UTI had ₹6,700 crores of assets under management.

**Second Phase – 1987-1993 (Entry of Public Sector Funds)**

1987 marked the entry of non-UTI, public sector mutual funds set up by public sector banks, Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990. At the end of 1993, the mutual fund industry had assets under management of ₹47,004 crores.

**Third Phase – 1993-2003 (Entry of Private Sector Funds)**

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India. The industry has also witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of ₹1,21,805 crores. The Unit Trust of India with ₹44,541 crores of assets under management was way ahead of other mutual funds.

**Fourth Phase – since February 2003**

In February 2003, following the repeal of the Unit Trust of India Act 1963, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of ₹29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India does not come under the purview of the Mutual Fund Regulations. The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than ₹76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth.
Moreover, in its effort to increase investor awareness, the industry and the Securities and Exchange Board of India (SEBI) have launched several initiatives. These include literature and campaigns to propagate financial education to various investor segments (including potential investors), such as school and college students, homemakers, executives, etc.

3. CLASSIFICATION OF MUTUAL FUNDS

There are three different types of classification of mutual funds - (1) Functional (2) Portfolio and (3) Ownership. Each classification is mutually exclusive.

3.1 Functional Classification

Funds are divided into:

(1) Open ended funds
(2) Close ended funds and

In an open ended scheme, the investor can make entry and exit at any time. Also, the capital of the fund is unlimited and the redemption period is indefinite. On the contrary, in a close ended scheme, the investor can buy into the scheme during Initial Public offering or from the stock market after the units have been listed. The scheme has a limited life at the end of which the corpus is liquidated. The investor can make his exit from the scheme by selling in the stock market, or at the expiry of the scheme or during repurchase period at his option. Interval schemes are a cross between an open ended and a close ended structure. These schemes are open for both purchase and redemption during pre-specified intervals (viz. monthly, quarterly, annually etc.) at prevailing NAV based prices. Interval funds are very similar to close-ended funds, but differ on the following points:

- They are not required to be listed on the stock exchanges, as they have an in-built redemption window.
- They can make fresh issue of units during the specified interval period, at the prevailing NAV based prices.
- Maturity period is not defined.

3.2 Portfolio Classification

Funds are classified into Equity Funds, Debt Funds and Special Funds.

Equity funds invest primarily in stocks. A share of stock represents a unit of ownership in a company. If a company is successful, shareholders can profit in two ways:

- the stock may increase in value, or
- the company can pass its profits to shareholders in the form of dividends.

If a company fails, a shareholder can lose the entire value of his or her shares; however, a shareholder is not liable for the debts of the company.
3.2.1 Equity Funds
Equity Funds are of the following types viz.

(a) **Growth Funds:** They seek to provide long term capital appreciation to the investor and are best to long term investors.

(b) **Aggressive Funds:** They look for super normal returns for which investment is made in start-ups, IPOs and speculative shares. They are best to investors willing to take risks.

(c) **Income Funds:** They seek to maximize present income of investors by investing in safe stocks paying high cash dividends and in high yield money market instruments. They are best to investors seeking current income.

(d) **Balanced Funds:** They are a mix of growth and income funds. They buy shares for growth and bonds for income and best for investors seeking to strike golden mean.

3.2.2 Debt Funds
Debt Funds are of two types viz.

(a) **Bond Funds:** They invest in fixed income securities e.g. government bonds, corporate debentures, convertible debentures, money market. Investors seeking tax free income go in for government bonds while those looking for safe, steady income buy government bonds or high grade corporate bonds. Although there have been past exceptions, bond funds tend to be less volatile than stock funds and often produce regular income. For these reasons, investors often use bond funds to diversify, provide a stream of income, or invest for intermediate-term goals. Like stock funds, bond funds have risks and can make or lose money.

(b) **Gilt Funds:** They are mainly invested in Government securities.

3.2.3 Special Funds
Special Funds are of four types viz.

(a) **Index Funds:** Every stock market has a stock index which measures the upward and downward sentiment of the stock market. Index Funds are low cost funds and influence the stock market. The investor will receive whatever the market delivers.

(b) **International Funds:** A mutual fund located in India to raise money in India for investing globally.

(c) **Offshore Funds:** A mutual fund located in India to raise money globally for investing in India.

(d) **Sector Funds:** They invest their entire fund in a particular industry e.g. utility fund for utility industry like power, gas, public works.

(e) **Money Market Funds:** These are predominantly debt-oriented schemes, whose main objective is preservation of capital, easy liquidity and moderate income. To achieve this objective, liquid funds invest predominantly in safer short-term instruments like Commercial Papers, Certificate of Deposits, Treasury Bills, G-Secs etc.
These schemes are used mainly by institutions and individuals to park their surplus funds for short periods of time. These funds are more or less insulated from changes in the interest rate in the economy and capture the current yields prevailing in the market.

(f) **Fund of Funds**: Fund of Funds (FoF) as the name suggests are schemes which invest in other mutual fund schemes. The concept is popular in markets where there are number of mutual fund offerings and choosing a suitable scheme according to one’s objective is tough. Just as a mutual fund scheme invests in a portfolio of securities such as equity, debt etc, the underlying investments for a FoF is the units of other mutual fund schemes, either from the same fund family or from other fund houses.

(g) **Capital Protection Oriented Fund**: The term ‘capital protection oriented scheme’ means a mutual fund scheme which is designated as such and which endeavours to protect the capital invested therein through suitable orientation of its portfolio structure. The orientation towards protection of capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover etc. SEBI stipulations require these types of schemes to be close-ended in nature, listed on the stock exchange and the intended portfolio structure would have to be mandatory rated by a credit rating agency. A typical portfolio structure could be to set aside major portion of the assets for capital safety and could be invested in highly rated debt instruments. The remaining portion would be invested in equity or equity related instruments to provide capital appreciation. Capital Protection Oriented schemes are a recent entrant in the Indian capital markets and should not be confused with ‘capital guaranteed’ schemes.

(h) **Gold Funds**: The objective of these funds is to track the performance of Gold. The units represent the value of gold or gold related instruments held in the scheme. Gold Funds which are generally in the form of an Exchange Traded Fund (ETF) are listed on the stock exchange and offers investors an opportunity to participate in the bullion market without having to take physical delivery of gold.
3.3 Ownership Classification

Funds are classified into Public Sector Mutual Funds, Private Sector Mutual Funds and Foreign Mutual Funds. Public Sector Mutual Funds are sponsored by a company of the public sector. Private Sector Mutual Fund is sponsored by a company of the private sector. Foreign Mutual Funds are sponsored by companies for raising funds in India, operate from India and invest in India.

3.4 Direct Plans in Mutual Funds

Asset management companies (AMC) have been permitted to make direct investments in mutual fund schemes even before 2011. But, there were no separate plans for these investments. These investments were made in distributor plan itself and were tracked with single NAV - one of the distributor plans. Therefore, an investor was forced to buy mutual funds based on the NAV of the distributor plans. However, things changed with introduction of direct plans by SEBI on January 1, 2013.

Mutual fund direct plans are those plan where Asset Management Companies or mutual fund Houses do not charge distributor expenses, trail fees and transaction charges. NAV of the direct plan are generally higher in comparison to a regular plan. Studies have shown that the ‘Direct Plans’ have performed better than the ‘Regular Plans’ for almost all the mutual fund schemes.

4. TYPES OF SCHEMES

4.1 Balanced Funds

Balanced funds make strategic allocation to both debt as well as equities. It mainly works on the premise that while the debt portfolio of the scheme provides stability, the equity one provides growth. It can be an ideal option for those who do not like total exposure to equity, but only substantial exposure. Such funds provide moderate returns to the investors as the investors are neither taking too high risk nor too low a risk.

4.2 Equity Diversified Funds

A Diversified funds is a fund that contains a wide array of stocks. The fund manager of a diversified fund ensures a high level of diversification in its holdings, thereby reducing the amount of risk in the fund.

a. Flexicap/ Multicap Fund: These are by definition, diversified funds. The only difference is that unlike a normal diversified fund, the offer document of a multi-cap/flexi-cap fund generally spells out the limits for minimum and maximum exposure to each of the market caps.

b. Contra fund: A contra fund invests in those out-of-favour companies that have unrecognised value. It is ideally suited for investors who want to invest in a fund that has the potential to perform in all types of market environments as it blends together both growth and value opportunities. Investors who invest in contra funds have an aggressive risk appetite.
c. **Index fund**: An index fund seeks to track the performance of a benchmark market index like the BSE Sensex or S&P CNX Nifty. Simply put, the fund maintains the portfolio of all the securities in the same proportion as stated in the benchmark index and earns the same return as earned by the market.

d. **Dividend Yield fund**: A dividend yield fund invests in shares of companies having high dividend yields. Dividend yield is defined as dividend per share divided by the share’s market price. Most of these funds invest in stocks of companies having a dividend yield higher than the dividend yield of a particular index, i.e., Sensex or Nifty. The prices of dividend yielding stocks are generally less volatile than growth stocks. Besides, they also offer the potential to appreciate.

Among diversified equity funds, dividend yield funds are considered to be a medium-risk proposition. However, it is important to note that dividend yield funds have not always proved resilient in short-term corrective phases. Dividend yield schemes are of two types:

- **Dividend Payout Option**: Dividends are paid out to the unit holders under this option. However, the NAV of the units falls to the extent of the dividend paid out and applicable statutory levies.

- **Dividend Re-investment Option**: The dividend that accrues on units under option is re-invested back into the scheme at ex-dividend NAV. Hence investors receive additional units on their investments in lieu of dividends.

### 4.3 Equity Linked Tax Savings Scheme

ELSS is one of the options for investors to save taxes under Section 80 C of the Income Tax Act. They also offer the perfect way to participate in the growth of the capital market, having a lock-in-period of three years. Besides, ELSS has the potential to give better returns than any traditional tax savings instrument.

Moreover, by investing in an ELSS through a Systematic Investment Plan (SIP), one can not only avoid the problem of investing a lump sum towards the end of the year but also take advantage of “averaging”.

### 4.4 Sector Funds

These funds are highly focused on a particular industry. The basic objective is to enable investors to take advantage of industry cycles. Since sector funds ride on market cycles, they have the potential to offer good returns if the timing is perfect. However, they are bereft of downside risk protection as available in diversified funds.

Sector funds should constitute only a limited portion of one’s portfolio, as they are much riskier than a diversified fund. Besides, only those who have an existing portfolio should consider investing in these funds.

For example, Real Estate Mutual Funds invest in real estate properties and earn income in the form of rentals, capital appreciation from developed properties. Also some part of the fund corpus is

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invested in equity shares or debentures of companies engaged in real estate assets or developing real estate development projects. REMFs are required to be close-ended in nature and listed on a stock exchange.

4.5 Thematic Funds

A Thematic fund focuses on trends that are likely to result in the ‘out-performance’ by certain sectors or companies. The theme could vary from multi-sector, international exposure, commodity exposure etc. Unlike a sector fund, theme funds have a broader outlook.

However, the downside is that the market may take a longer time to recognize views of the fund house with regards to a particular theme, which forms the basis of launching a fund.

4.6 Arbitrage Funds

Typically, these funds promise safety of deposits, but better returns, tax benefits and greater liquidity. Pru-ICICI is the latest to join the list with its equities and derivatives funds.

The open ended equity scheme aims to generate low volatility returns by inverting in a mix of cash equities, equity derivatives and debt markets. The fund seeks to provide better returns than typical debt instruments and lower volatility in comparison to equity.

This fund is aimed at an investor who seeks the return of small savings instruments, safety of bank deposits, tax benefits of RBI relief bonds and liquidity of a mutual fund.

Arbitrage fund finally seeks to capitalize on the price differentials between the spot and the futures market.

The other schemes in the arbitrage universe are Benchmark Derivative, JM Equity and Derivatives, Prudential ICICI Balanced, UTI Spread and Prudential ICICI Equity and Derivatives.

4.7 Hedge Fund

A hedge fund (there are no hedge funds in India) is a lightly regulated investment fund that escapes most regulations by being a sort of a private investment vehicle being offered to selected clients.

The big difference between a hedge fund and a mutual fund is that the former does not reveal anything about its operations publicly and charges a performance fee. Typically, if it outperforms a benchmark, it take a cut off the profits. Of course, this is a one way street, any losses are borne by the investors themselves. Hedge funds are aggressively managed portfolio of investments which use advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). It is important to note that hedging is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment.
4.8 Cash Fund

Cash Fund is an open-ended liquid scheme that aims to generate returns with lower volatility and higher liquidity through a portfolio of debt and money market instruments.

The fund will have retail institutional and super institutional plans. Each plan will offer growth and dividend options. The minimum initial investment for the institutional plan is ₹ 1 crore and the super institutional is ₹ 25 crore. For the retail plan, the minimum initial investment is ₹ 5,000/-. The fund has no entry or exit loads. Investors can invest even through the Systematic Investment Planning (SIP) route with a minimum amount of ₹ 500 per instalment with the total of all instalments not being less than ₹ 5,000/-.

4.9 Exchange Traded Funds

An Exchange Traded Fund (ETF) is a hybrid product that combines the features of an index fund. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETFs can be bought and sold like any other stock on an exchange. In other words, ETFs can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. Therefore, one can invest at real-time prices as against the end of the day prices as in the case with open-ended schemes.

There is no paperwork involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. Following types of ETF products are available in the market:

- **Index ETFs** - Most ETFs are index funds that hold securities and attempt to replicate the performance of a stock market index.
- **Commodity ETFs** - Commodity ETFs invest in commodities, such as precious metals and futures.
- **Bond ETFs** - Exchange-traded funds that invest in bonds are known as bond ETFs. They thrive during economic recessions because investors pull their money out of the stock market and into bonds (for example, government treasury bonds or those issues by companies regarded as financially stable). Because of this cause and effect relationship, the performance of bond ETFs may be indicative of broader economic conditions.
- **Currency ETFs** - The funds are total return products where the investor gets access to the FX spot change, local institutional interest rates and a collateral yield.
4.10 Fixed Maturity Plans

Fixed Maturity Plans (FMPs) are closely ended mutual funds in which an investor can invest during a New Fund Offer (NFO). FMPs usually invest in Certificates of Deposits (CDs), Commercial Papers (CPs), Money Market Instruments and Non-Convertible Debentures over fixed investment period. Sometimes, they also invest in Bank Fixed Deposits.

In New Fund Offers, during the course of which FMPs are issued, are later traded on the stock exchange where they are listed. But, the trading in FMPs is very less. So, basically FMPs are not liquid instruments.

The main advantage of Fixed Maturity Plans is that they are free from any interest rate risk because FMPs invest in debt instruments that have the same maturity as that of the fund. However, they carry credit risk, as there is a possibility of default by the debt issuing company. So, if the credit rating of an instrument is downgraded, the returns of FMP can come down.

Presently, most of the FMPs are launched with tenure of three years to take the benefit of indexation. But, because of the longer maturity period they find it difficult to provide good returns in the form of interest to the investors in highest rated instruments. They, therefore assign some portions of the invested funds in AA and below rated debt instruments to earn higher interest. The reason is that lower rated instruments carry higher coupon rates than higher rated instruments.

5. ADVANTAGES OF MUTUAL FUND

(a) **Professional Management:** The funds are managed by skilled and professionally experienced managers with a back up of a Research team.

(b) **Diversification:** Mutual Funds offer diversification in portfolio which reduces the risk.

(c) **Convenient Administration:** There are no administrative risks of share transfer, as many of the Mutual Funds offer services in a demat form which save investor's time and delay.

(d) **Higher Returns:** Over a medium to long-term investment, investors always get higher returns in Mutual Funds as compared to other avenues of investment. This is already seen from excellent returns, Mutual Funds have provided in the last few years. However, investors are cautioned that such high returns riding on the IT boom should not be taken as regular returns and therefore one should look at the average returns provided by the Mutual Funds particularly in the equity schemes during the last couple of years.

(e) **Low Cost of Management:** No Mutual Fund can increase the cost beyond prescribed limits of 2.5% maximum and any extra cost of management is to be borne by the AMC.

(f) **Liquidity:** In all the open ended funds, liquidity is provided by direct sales / repurchase by the Mutual Fund and in case of close ended funds, the liquidity is provided by listing the units on the Stock Exchange.
(g) **Transparency:** The SEBI Regulations now compel all the Mutual Funds to disclose their portfolios on a half-yearly basis. However, many Mutual Funds disclose this on a quarterly or monthly basis to their investors. The NAVs are calculated on a daily basis in case of open ended funds and are now published through AMFI in the newspapers.

(h) **Other Benefits:** Mutual Funds provide regular withdrawal and systematic investment plans according to the need of the investors. The investors can also switch from one scheme to another without any load.

(i) **Highly Regulated:** Mutual Funds all over the world are highly regulated and in India all Mutual Funds are registered with SEBI and are strictly regulated as per the Mutual Fund Regulations which provide excellent investor protection.

(j) **Economies of scale:** The way mutual funds are structured gives it a natural advantage. The “pooled” money from a number of investors ensures that mutual funds enjoy economies of scale; it is cheaper compared to investing directly in the capital markets which involves higher charges. This also allows retail investors access to high entry level markets like real estate, and also there is a greater control over costs.

(k) **Flexibility:** There are a lot of features in a regular mutual fund scheme, which imparts flexibility to the scheme. An investor can opt for Systematic Investment Plan (SIP), Systematic Withdrawal Plan etc. to plan his cash flow requirements as per his convenience. The wide range of schemes being launched in India by different mutual funds also provides an added flexibility to the investor to plan his portfolio accordingly.

### 6. DRAWBACKS OF MUTUAL FUND

(a) **No guarantee of Return** – There are three issues involved:

(i) All Mutual Funds cannot be winners. There may be some who may underperform the benchmark index i.e. it may not even perform well as a novice who invests in the stocks constituting the index.

(ii) A mutual fund may perform better than the stock market but this does not necessarily lead to a gain for the investor. The market may have risen and the mutual fund scheme increased in value but the investor would have got the same increase had he invested in risk free investments than in mutual fund.

(iii) Investors may forgive if the return is not adequate. But they will not do so if the principal is eroded. Mutual Fund investment may depreciate in value.

(b) **Diversification** – A mutual fund helps to create a diversified portfolio. Though diversification minimizes risk, it does not ensure maximizing returns. The returns that mutual funds offer are less than what an investor can achieve. For example, if a single security held by a mutual fund doubles in value, the mutual fund itself would not double in value because that security is only one small part of the fund’s holdings. By holding a large number of different investments, mutual funds tend to do neither exceptionally well nor exceptionally poor.
7.14 STRATEGIC FINANCIAL MANAGEMENT

(c) **Selection of Proper Fund** – It may be easier to select the right share rather than the right fund. For stocks, one can base his selection on the parameters of economic, industry and company analysis. In case of mutual funds, past performance is the only criteria to fall back upon. But past cannot predict the future.

(d) **Cost Factor** – Mutual Funds carry a price tag. Fund Managers are the highest paid executives. While investing, one has to pay for entry load and when leaving he has to pay for exit load. Such costs reduce the return from mutual fund. The fees paid to the Asset Management Company is in no way related to performance.

(e) **Unethical Practices** – Mutual Funds may not play a fair game. Each scheme may sell some of the holdings to its sister concerns for substantive notional gains and posting NAVs in a formalized manner.

(f) **Taxes** – When making decisions about your money, fund managers do not consider your personal tax situations. For example when a fund manager sells a security, a capital gain tax is triggered, which affects how profitable the individual is from sale. It might have been more profitable for the individual to defer the capital gain liability.

(g) **Transfer Difficulties** – Complications arise with mutual funds when a managed portfolio is switched to a different financial firm. Sometimes the mutual fund positions have to be closed out before a transfer can happen. This can be a major problem for investors. Liquidating a mutual fund portfolio may increase risk, increase fees and commissions, and create capital gains taxes.

7. TERMS ASSOCIATED WITH MUTUAL FUNDS

7.1 **Net Asset Value (NAV)**

It is the amount which a unit holder would receive if the mutual fund were wound up. An investor in mutual fund is a part owner of all its assets and liabilities. Returns to the investor are determined by the interplay of two elements, Net Asset Value and Costs of Mutual Fund. Net Asset Value is the mutual fund’s calling card. It is the basis for assessing the return that an investor has earned. There are three aspects which need to be highlighted:

(i) It is the net value of all assets less liabilities. NAV represents the market value of total assets of the Fund less total liabilities attributable to those assets.

(ii) NAV changes daily. The value of assets and liabilities changes daily. NAV today will not be NAV tomorrow or day later.

(iii) NAV is computed on per unit basis i.e. dividing the Net Asset Value by number of Outstanding Units.

*How Net Asset Value is calculated?*

It is value of net assets of the funds. The investor’s subscription is treated as the unit capital in the
balance sheet of the fund and the investments on their behalf are treated as assets. The fund’s net assets are defined as the assets less liabilities.

\[
\text{NAV} = \frac{\text{Net asset of the scheme}}{\text{Number of units outstanding}}
\]

Where net assets of the scheme is defined as below -

\[
\text{Net Assets of the Scheme} = \text{Market value of investments} + \text{Receivables} + \text{Other accrued income} + \text{other assets} - \text{Accrued Expenses} - \text{Other Payables} - \text{Other Liabilities}
\]

### 7.2 Entry and Exit Load in Mutual Funds

Some Asset Management Companies (AMCs) have sales charges, or loads, on their funds (entry load and/or exit load) to compensate for distribution costs. Funds that can be purchased without a sales charge are called no-load funds.

Entry load is charged at the time an investor purchases the units of a scheme. The entry load percentage is added to the prevailing NAV at the time of allotment of units.

Exit load is charged at the time of redeeming (or transferring an investment between schemes). The exit load percentage is deducted from the NAV at the time of redemption (or transfer between schemes). This amount goes to the Asset Management Company and not into the pool of funds of the scheme. In simple terms, therefore, Entry and Exit Load in Mutual Fund are the charges one pays while buying and selling the fund respectively.

**Example**

Mr. X earns 10% on his investments in equity shares. He is considering a recently floated scheme of a Mutual Fund where the initial expenses are 6% and annual recurring expenses are expected to be 2%. How much the Mutual Fund scheme should earn to provide a return of 10% to Mr. X?

**Answer**

\[
r_2 = \frac{1}{1 - \text{initial exp}} \times r_1 + \text{recurring exp.}
\]

The rate of return the mutual fund should earn;\( = \frac{1}{1 - 0.06} \times 0.1 + 0.02 = 0.1264 \) or 12.64%

### 7.3 Trail Commission

It is the amount that a mutual fund investor pays to his advisor each year. The purpose of charging this commission from the investor is to provide incentive to the advisor to review their customer’s holdings and to give advice from time to time.

Distributors usually charge a trail commission of 0.3-0.75% on the value of the investment for each year that the investor’s money remains invested with the fund company.
7.16 STRATEGIC FINANCIAL MANAGEMENT

This is calculated on a daily basis as a percentage of the assets under management of the distributor and is paid monthly. This is separate from any upfront commission that is usually paid by the fund company to the distributor out of its own pocket.

7.4 Expense Ratio

It is the percentage of the assets that were spent to run a mutual fund. It includes things like management and advisory fees, travel costs and consultancy fees. The expense ratio does not include brokerage costs for trading the portfolio. It is also referred to as the Management Expense Ratio (MER).

Paying close attention to the expense ratio is necessary. The reason is it can sometimes be as high as 2-3% which can seriously undermine the performance of a mutual fund.

7.5 Side Pocketing

In simple words, a Side Pocketing in Mutual Funds leads to separation of risky assets from other investments and cash holdings. The purpose is to make sure that money invested in a mutual fund, which is linked to stressed assets, gets locked, until the fund recovers the money from the company or could avoid distress selling of illiquid securities.

The modus operandi is simple. Whenever, the rating of a mutual fund decreases, the fund shifts the illiquid assets into a side pocket so that current shareholders can be benefitted from the liquid assets. Consequently, the Net Asset Value (NAV) of the fund will then reflect the actual value of the liquid assets.

Side Pocketing is beneficial for those investors who wish to hold on to the units of the main funds for long term. Therefore, the process of Side Pocketing ensures that liquidity is not the problem even in the circumstances of frequent allotments and redemptions.

Side Pocketing is quite common internationally. However, Side Pocketing has also been resorted to bereft the investors of genuine returns.

In India recent fiasco in the Infrastructure Leasing and Financial Services (IL&FS) has led to many discussions on the concept of side pocketing as IL&FS and its subsidiaries have failed to fulfill its repayments obligations due to severe liquidity crisis.

The Mutual Funds have given negative returns because they have completely written off their exposure to IL&FS instruments.

7.6 Tracking Error

Tracking error can be defined as the divergence or deviation of a fund’s return from the benchmarks return it is following.

The passive fund managers closely follow or track the benchmark index. Although they design their investment strategy on the same index but often it may not exactly replicate the index return. In such situation, there is possibility of deviation between the returns.
The tracking error can be calculated on the basis of corresponding benchmark return vis a vis quarterly or monthly average NAVs.

Higher the tracking error higher is the risk profile of the fund. Whether the funds outperform or underperform their benchmark indices; it clearly indicates that fund managers are not following the benchmark indices properly. In addition to the same other reason for tracking error are as follows:

- Transaction cost
- Fees charged by AMCs
- Fund expenses
- Cash holdings
- Sampling biasness

Thus from above it can be said that to replicate the return to any benchmark index the tracking error should be near to zero.

The Tracking Error is calculated as follows:

\[ TE = \sqrt{\frac{\sum (d - \bar{d})}{n-1}} \]

where:
- \( d \) = Differential return
- \( \bar{d} \) = Average differential return
- \( n \) = No. of observation

**TEST YOUR KNOWLEDGE**

**Theoretical Questions**
1. Explain how to establish a Mutual Fund.
2. What are the advantages of investing in Mutual Funds?

**Practical Questions**
1. Mr. A can earn a return of 16 per cent by investing in equity shares on his own. Now he is considering a recently announced equity based mutual fund scheme in which initial expenses are 5.5 per cent and annual recurring expenses are 1.5 per cent. How much should the mutual fund earn to provide Mr. A return of 16 per cent?

2. A mutual fund that had a net asset value of ₹16 at the beginning of a month, made income and capital gain distribution of ₹0.04 and ₹0.03 respectively per unit during the month, and
then ended the month with a net asset value of ₹16.08. Calculate monthly and annual rate of return.

3. Cinderella Mutual Fund has the following assets in Scheme Rudolf at the close of business on 31st March, 2014.

<table>
<thead>
<tr>
<th>Company</th>
<th>No. of Shares</th>
<th>Market Price Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nairobi Ltd.</td>
<td>25000</td>
<td>₹ 20</td>
</tr>
<tr>
<td>Dakar Ltd.</td>
<td>35000</td>
<td>₹ 300</td>
</tr>
<tr>
<td>Senegal Ltd.</td>
<td>29000</td>
<td>₹ 380</td>
</tr>
<tr>
<td>Cairo Ltd.</td>
<td>40000</td>
<td>₹ 500</td>
</tr>
</tbody>
</table>

The total number of units of Scheme Rudolf are 10 lacs. The Scheme Rudolf has accrued expenses of ₹ 2,50,000 and other liabilities of ₹ 2,00,000. Calculate the NAV per unit of the Scheme Rudolf.

4. A Mutual Fund Co. has the following assets under it on the close of business as on:

<table>
<thead>
<tr>
<th>Company</th>
<th>No. of Shares</th>
<th>1st February 2012</th>
<th>2nd February 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Market price per share</td>
<td>Market price per share</td>
</tr>
<tr>
<td></td>
<td></td>
<td>₹</td>
<td>₹</td>
</tr>
<tr>
<td>L Ltd</td>
<td>20,000</td>
<td>20.00</td>
<td>20.50</td>
</tr>
<tr>
<td>M Ltd</td>
<td>30,000</td>
<td>312.40</td>
<td>360.00</td>
</tr>
<tr>
<td>N Ltd</td>
<td>20,000</td>
<td>361.20</td>
<td>383.10</td>
</tr>
<tr>
<td>P Ltd</td>
<td>60,000</td>
<td>505.10</td>
<td>503.90</td>
</tr>
</tbody>
</table>

Total No. of Units 6,00,000

(i) Calculate Net Assets Value (NAV) of the Fund.

(ii) Following information is given:
Assuming one Mr. A, submits a cheque of ₹ 30,00,000 to the Mutual Fund and the Fund manager of this company purchases 8,000 shares of M Ltd; and the balance amount is held in Bank. In such a case, what would be the position of the Fund?

(iii) Find new NAV of the Fund as on 2nd February 2012.

Answers to Theoretical Questions

1. Establishment of a Mutual Fund: A mutual fund is required to be registered with the Securities and Exchange Board of India (SEBI) before it can collect funds from the public. All mutual funds are governed by the same set of regulations and are subject to monitoring and inspections by the SEBI. The Mutual Fund has to be established through the medium of a
A sponsor means any body corporate who, acting alone or in combination with another body corporate, establishes a mutual fund after completing the formalities prescribed in the SEBI's Mutual Fund Regulations.

The role of sponsor is akin to that of a promoter of a company, who provides the initial capital and appoints the trustees. The sponsor should be a body corporate in the business of financial services for a period not less than 5 years, be financially sound and be a fit party to act as sponsor in the eyes of SEBI.

The Mutual Fund has to be established as either a trustee company or a Trust, under the Indian Trust Act and the instrument of trust shall be in the form of a deed. The deed shall be executed by the sponsor in favour of the trustees named in the instrument of trust. The trust deed shall be duly registered under the provisions of the Indian Registration Act, 1908. The trust deed shall contain clauses specified in the Third Schedule of the Regulations.

An Asset Management Company, who holds an approval from SEBI, is to be appointed to manage the affairs of the Mutual Fund and it should operate the schemes of such fund. The Asset Management Company is set up as a limited liability company, with a minimum net worth of ₹ 10 crores.

The sponsor should contribute at least 40% to the networth of the Asset Management Company. The Trustee should hold the property of the Mutual Fund in trust for the benefit of the unit holders.

SEBI regulations require that at least two-thirds of the directors of the Trustee Company or board of trustees must be independent, that is, they should not be associated with the sponsors. Also, 50 per cent of the directors of AMC must be independent. The appointment of the AMC can be terminated by majority of the trustees or by 75% of the unit holders of the concerned scheme.

The AMC may charge the mutual fund with Investment Management and Advisory fees subject to prescribed ceiling. Additionally, the AMC may get the expenses on operation of the mutual fund reimbursed from the concerned scheme.

The Mutual fund also appoints a custodian, holding valid certificate of registration issued by SEBI, to have custody of securities held by the mutual fund under different schemes. In case of dematerialized securities, this is done by Depository Participant. The custodian must be independent of the sponsor and the AMC.
2. Please refer paragraph 5

**Answers to the Practical Questions**

1. Personal earnings of Mr. A = $R_1 = 16\%$

Mutual Fund earnings = $R_2$

$$R_2 = \frac{1}{1 - \text{Initial expenses } (\%) + R_1 + \text{Recurring expenses } (\%)}$$

$$= \frac{1}{1 - 0.055 \times 16\% + 1.5\%}$$

$$= 18.43\%$$

Mutual Fund earnings = 18.43\%

2. Calculation of monthly return on the mutual funds:

$$r = \frac{(\text{NAV}_{t} - \text{NAV}_{t-1}) + I_t + G_t}{\text{NAV}_{t-1}}$$

Or, $r = \frac{(\¥ 16.08 - \¥ 16.00) + (\¥ 0.04 + \¥ 0.03)}{16}$

$$= \frac{0.08 + 0.07}{16} = 0.009375$$

or, $r = 0.9375\%$ or 11.25\% p.a.
3. Shares

<table>
<thead>
<tr>
<th>Shares</th>
<th>No. of shares</th>
<th>Price</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nairobi Ltd.</td>
<td>25,000</td>
<td>20.00</td>
<td>5,00,000</td>
</tr>
<tr>
<td>Dakar Ltd.</td>
<td>35,000</td>
<td>300.00</td>
<td>1,05,00,000</td>
</tr>
<tr>
<td>Senegal Ltd.</td>
<td>29,000</td>
<td>380.00</td>
<td>1,10,20,000</td>
</tr>
<tr>
<td>Cairo Ltd.</td>
<td>40,000</td>
<td>500.00</td>
<td>2,00,00,000</td>
</tr>
</tbody>
</table>

Less: Accrued Expenses 2,50,000
Other Liabilities 2,00,000

Total Value 4,15,70,000

No. of Units 10,00,000

NAV per Unit (4,15,70,000/10,00,000) 41.57

4. (i) NAV of the Fund

\[
= \frac{4,00,000 + 93,72,000 + 72,24,000 + 3,03,06,000}{6,00,000} \\
= \frac{4,73,02,000}{6,00,000} = ₹ 78.8366 \text{ rounded to ₹ 78.84}
\]

(ii) The revised position of fund shall be as follows:

<table>
<thead>
<tr>
<th>Shares</th>
<th>No. of shares</th>
<th>Price</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>L Ltd.</td>
<td>20,000</td>
<td>20.00</td>
<td>4,00,000</td>
</tr>
<tr>
<td>M Ltd.</td>
<td>38,000</td>
<td>312.40</td>
<td>1,18,71,200</td>
</tr>
<tr>
<td>N Ltd.</td>
<td>20,000</td>
<td>361.20</td>
<td>72,24,000</td>
</tr>
<tr>
<td>P Ltd.</td>
<td>60,000</td>
<td>505.10</td>
<td>3,03,06,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>5,00,800</td>
</tr>
</tbody>
</table>

Cash Total 5,00,800

No. of units of fund = 6,00,000 + \frac{30,00,000}{78.8366} = 6,38,053
(iii) On 2nd February 2012, the NAV of fund will be as follows:

<table>
<thead>
<tr>
<th>Shares</th>
<th>No. of shares</th>
<th>Price</th>
<th>Amount (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>L Ltd.</td>
<td>20,000</td>
<td>20.50</td>
<td>4,10,000</td>
</tr>
<tr>
<td>M Ltd.</td>
<td>38,000</td>
<td>360.00</td>
<td>1,36,80,000</td>
</tr>
<tr>
<td>N Ltd.</td>
<td>20,000</td>
<td>383.10</td>
<td>76,62,000</td>
</tr>
<tr>
<td>P Ltd.</td>
<td>60,000</td>
<td>503.90</td>
<td>3,02,34,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>5,00,800</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>5,24,86,800</td>
</tr>
</tbody>
</table>

NAV as on 2nd February 2012 = ₹ 5,24,86,800
                                      6,38,053
                                          = ₹ 82.26 per unit