Mutual Funds

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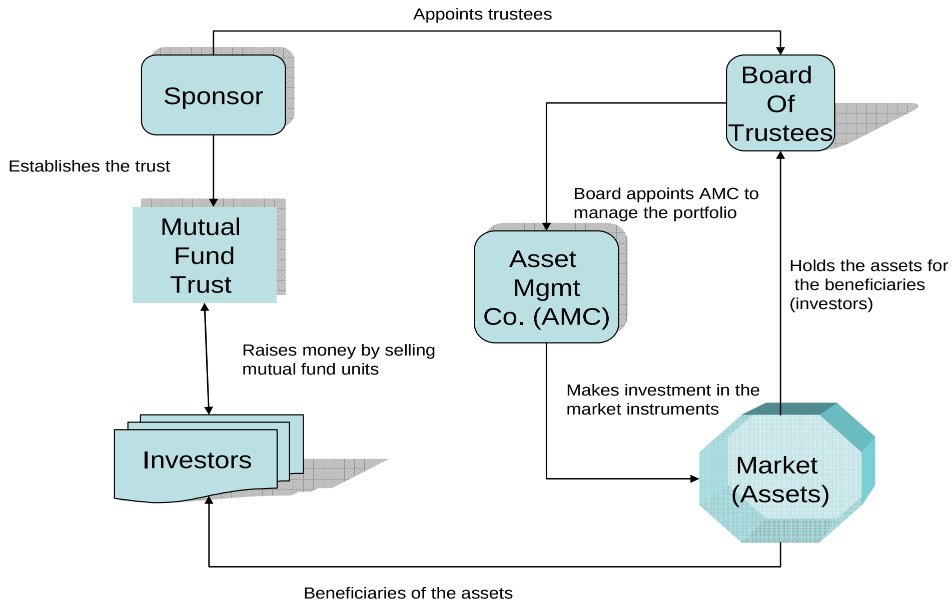
What are mutual funds?

It is a trust that pools together resources of investors to make a foray into investments in capital markets, thereby making investors part owners of the assets of mutual funds.

Savings and investments are perpetual and every individual would like to maximize the returns on the investments. Mutual funds provide the leverage of earning higher returns with little savings. This can be explained in the following manner; if an individual has Rs.5000 as savings, he may invest in few stocks and create a portfolio of his own, but his returns would be limited to changes in the market value of the share and dividends from the stocks. He would be exposed to the risk of those stocks not performing well. Whereas in case of mutual funds, with little investment, you get a share of larger portfolio and the risk is diversified to lot many stocks in the portfolio. As a matter of financial discipline, if I have Rs.1000 per month to invest in, I can invest in a fund every month through a Systematic Investment Plan (SIP)

So by investing in mutual funds you are not only putting your eggs in different baskets but also overcoming the limitation of the quantum of investment in hand and you can do away with the burden of managing you portfolio of your own as this is being ‘outsourced’ to a fund manager having expertise in the field

Players in the industry:



Players in Mutual Funds:

- **Sponsor** – Runs the show, akin the promoters of a Company. The SEBI (Mutual Funds) Regulations, 1996, defines *sponsor* as any person who, acting alone or in combination with another body corporate, establishes a mutual fund. The sponsor forms the Trust and appoints the board of trustees, appoints the AMC as the fund managers and may also appoint custodian to hold the fund assets. As per the SEBI (Mutual Fund) Regulations, 1996, sponsor makes an application for registration of the mutual fund and contributes atleast 40% of the net worth of the asset management company. The sponsor must comply with the eligibility criteria without which the Board may reject the application. Eligibility criteria for grant of certificate of registration are that the sponsor should
  - *(i)* have a sound track record and general reputation of fairness and integrity in all his business transactions.
  - *(ii)* the applicant is a fit and proper person
  - *(iii)* in the case of an existing mutual fund, such fund is in the form of a trust and the trust deed has been approved by the Board;
  - *(iv)* the sponsor has contributed or contributes at least 40% to the net worth of the asset management company:
  - *(v)* the sponsor or any of its directors or the principal officer to be employed by the mutual fund should not have been guilty of fraud or has not been convicted of an offence involving moral turpitude or has not been found guilty of any economic offence;
  - *(vi)* appointment of trustees to act as trustees for the mutual fund in accordance with the provisions of the regulations;

(vii) appointment of asset management company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations;

(viii) appointment of custodian in order to keep custody of the securities or gold and gold related instrument or other assets of the mutual fund held in terms of these regulations, and provide such other custodial services as may be authorised by the trustees

Sound track record here means:

(i) be carrying on business in financial services for a period of not less than five years; and

(ii) the networth is positive in all the immediately preceding five years; and

(iii) the networth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and

(iv) the sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year

- **Asset Management Company** – AMC acts as an investment manager of the Trust. AMC's float and manage different investment schemes in the name of the Trust. **Restrictions on AMC are**:
    - Not act as a trustee of any mutual fund
    - Not undertake any activity conflicting with the activities of the mutual fund
    - AMC shall not invest in any of its schemes unless intention to invest has been made in the offer document

  Obligations of AMCs are:
    - AMC shall not carry transactions with any broker whether associated with sponsor or not; for average of 5% or more; with exceptions
    - Ensure regulatory compliances & approvals when required
    - Liable to mutual funds for the acts of omission & commission
    - Details of directors, their interest in other companies; changes in interest to be submitted to the trustees
    - Fund manager to ensure that the funds of the scheme are invested to meet the objectives of the scheme
    - Due diligence and care in all investment decisions
    - AMC shall not utilize the services of any sponsor or its associates etc
    - AMCs to make half yearly disclosures for:
        - Underwriting obligations
        - Devolvement
        - Subscriptions in the schemes lead managed by associates
        - Subscriptions to debt/ equity issues where sponsors/ associates acted as arranger/ lead manager
- **Trustee –** Trustees hold unit holders' money in fiduciary capacity. Two thirds of the trustees shall be independent persons and shall not be associated with sponsors

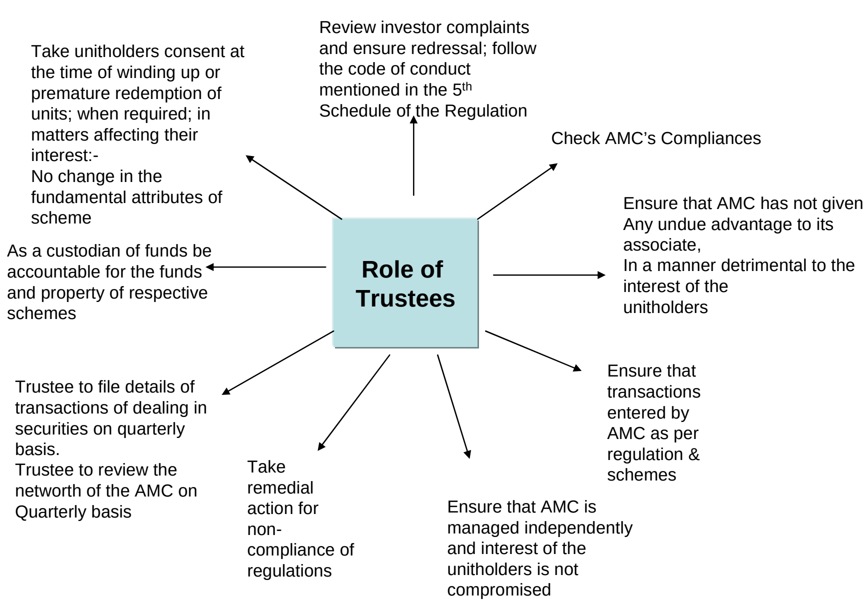
in any manner. The Eligibility Criteria for a trustee and the rights and obligations of the trustees as stated in the SEBI (Mutual Fund) Regulations, 1996 are as follows:

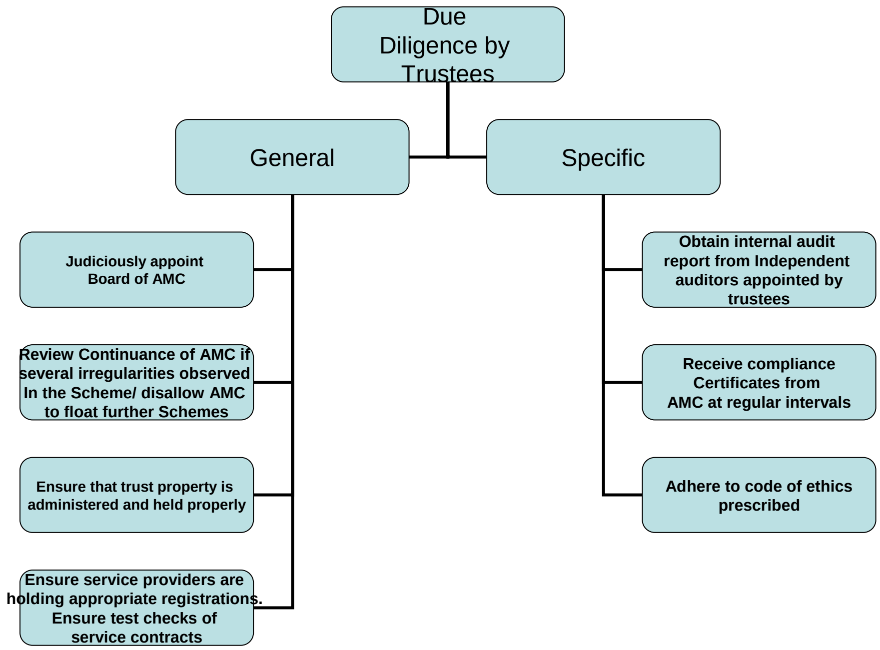
Eligibility criteria for being a trustee:

No person shall be eligible to be appointed as a trustee unless—

(a) he is a person of ability, integrity and standing; and
(b) has not been found guilty of moral turpitude; and
(c) has not been convicted of any economic offence or violation of any securities laws;
(d) has furnished particulars as specified in Form C.
(e) No asset management company and no director (including independent director), officer or employee of an asset management company shall be eligible to be appointed as a trustee of any mutual fund
(f) No person who is appointed as a trustee of a mutual fund shall be eligible to be appointed as a trustee of any other mutual fund
(g) Two-thirds of the trustees shall be independent persons and shall not be associated with the sponsors or be associated with them in any manner whatsoever
(h) In case a company is appointed as a trustee then its directors can act as trustees of any other trust provided that the object of the trust is not in conflict with the object of the mutual fund.

Role of a Trustee:





- **Unit Holder –** General public that invests in the schemes floated by AMC's.
- **Mutual Fund –** It is the 'pass through vehicle,' constituted in a form of a Public Trust, which holds the assets of the trust for the benefit of the unit-holders, beneficiaries of the trust
- **Custodian/ Depositories –** They hold the physical/ dematerialized securities of mutual fund
- **Transfer Agents –** They are responsible for issuing and redeeming units of mutual funds and provide other related services such as preparation of transfer documents and updating investors' records.

Benefits of investing in mutual funds:

- **Diversification –** As discussed above, the portfolio is diversified, so it reduces the risk
- **Professionally managed –** These funds are managed by skilled professionals, with experience and expertise
- **Administrative Advantage –** Mutual Funds offer services in demat mode, so it saves time investor's time and risk of delay in share transfer etc
- **Higher Returns –** Returns are usually higher than other avenues of investment
- **At relatively low cost –** Mutual funds cannot increase the charge beyond 2.5%, any cost over and above the prescribed limit is borne by the Asset Management Company (AMC)

- **Liquidity –** In case of an open ended funds, liquidity is provided by direct sales or repurchase by the Mutual Funds and in case of close ended funds, liquidity is provided by listing of the units on Stock Exchange (terms explained later)
- **Transparency –** Mutual Funds are regulated by SEBI and have to disclose the portfolio on a half yearly basis. NAVs are calculated on daily basis in case of open ended funds and published in newspapers for investors' knowledge
- **Flexibility –** Some Mutual funds provide investors the flexibility of switching from one scheme to other without any load
- Mutual funds offer the benefit of investing in the portfolio of your choice depending upon the risk/ return you want out of our investments

Drawbacks of investments in Mutual Funds:

- **No guarantee on returns –** the returns on Mutual Funds investments are not guaranteed. There may be such situation where the proportionate increase in the value of the mutual fund may be the same or less than what an investor would have received had he invested in risk free securities. Sometimes Mutual Funds may depreciate in value as well
- **Diversification –** Diversification reduces risks, but too much of diversification can effect returns as well
- **Fund Selection –** It the premises for investments are not proper
- **Cost Factor –** The cost payable to the fund managers may not be related to the performance of the fund. In this case the cost factor would be a drawback for the investors

Brief process of functioning of the mutual funds:

The process of registering/ functioning of mutual funds is:

1. a sponsor has to make an application in Form A along with the requisite fees to the Board (SEBI). Grant of certificate of registration is given by the Board in Form B. Thereafter each mutual fund must pay an annual service fee, in case of failure to pay the annual fee, the Board may not permit the mutual fund to launch any scheme
2. Mutual Fund has to be established in the form of a Trust and the deed has to be registered under the Indian Registration Act, 1908, the deed being duly executed by the sponsor in the name of the trustees as mentioned in the deed
    a. The purpose of the trust deed is to safeguard interest of the unitholders and thus states the rights, obligations and liabilities of the trust in relation to the mutual fund or the unitholders
    b. The contents of the trust deed will broadly include the following clauses:
        i. Unitholders would have beneficial interest in the trust property to the extent of individual holdings in the respective schemes
        ii. Liabilities & duties of the trustees, right to appoint/ dismiss asset management company

            iii. Right to forbid the mutual funds from making investments which are detrimental to the interests of the unitholders
            iv. Minimum number of trustees, trusteeship fees, removal of members, number of meetings, quorum for the meeting etc
            v. Disclosures of particulars of interests of the trustees in other companies, institution, financial intermediary or any body corporate
    c. Appointed trustees need to furnish their details in Form C to the Board – approval of the Board is must for the appointment of Trustees
    d. The trustees and/ or the sponsors appoint the Asset Management Company. The trustees and AMC with the prior approval of the Board enter into an investment management agreement (Clauses of the investment management agreement are mentioned in the Fourth Schedule of the Regulation). Application Form D to be submitted to the Board for appointment of AMC
3. Scheme to be launched with the approval of the trustees and offer document filed with the Board. Offer document disclosures will include:
    a. Adequate information to enable investors make investment decisions
    b. Application form for investing in units to contain the information memorandum
    c. Mention of prior in-principle approval of stock exchanges, if listing of units to be carried out
4. Advertisement of each scheme to disclose the investment objective of the scheme
5. Once units sold, there are restrictions on investments specified in the Regulations
6. Valutions of the investments in the portfolio are carried out regularly and published
7. Liquidity options are provided both in case of open ended and close ended schemes

Evaluating Performance of Mutual Funds:

Net Asset Value is the amount a unit holder would receive if the mutual fund were wound up, it is also called the mutual fund's *calling card*. Since the unit holders are part owners of the assets and liabilities of the mutual fund, NAV is the net value of all assets and liabilities, i.e the market value of total assets and market value of total liabilities. What is the peculiar to NAV is:

- NAV changes daily
- NAV is computed as a value per unit holding
- Returns to the investor are determined by Cost of Mutual Fund and Net Asset Value

Computation of NAV:

NAV = Net assets of the scheme

Number of units outstanding

Where;

Net assets of the scheme = Market value of investments + receivables + other accrued income + other assets – Accrued expenses – other payables – other liabilities

Cost component of Mutual Funds: It is quite evident, higher the cost, lower would be return for investors. The cost component can be divided into 2:

- **Initial expenses –** incurred for establishing the scheme. These expenses are not charged on the year of expenditure but are amortized over a period of time
  - In case of close ended scheme floated on load basis, issue expenses are amortised on weekly basis over the period of scheme
  - In case of open ended scheme floated on load basis, initial expenses are amortised over a period not exceeding 5 years
- **Recurring expenses – also called Operating cost.**
  - Cost of investment analysts/ advisory fees
  - Administrative cost
  - Advertisement cost

Management expenses ratio: Expenses are measured as a % of the average value of portfolio. The ratio is as follows:

$$\text{Expenses Ratio} = \frac{\text{Expenses}}{\text{Average value of portfolio}}$$

Expenses can be also be expressed per unit, then the ratio is:

$$\text{Expenses per unit} = \frac{\text{Expenses incurred per unit}}{\text{Average net value of assets}}$$

Sales Charges: Sales charges or sales load are directly charged to the investor and are used to make payment with regard to agents' commission and expenses for distribution and marketing. Sales charges are directly collected from the investor as front end load or back end load

- **Front end load**: One time fixed fee paid by the investor while buying into the scheme. This helps you determine, how much of the initial investment gets invested. Front end load amount decreases as the initial investment amount increases. Public Offer Price (POP) is calculated in the following manner:

  Public Offer Price = <u>Net Asset Value</u>

(1-Front end load)

- **Back end load**: This is fixed fee paid at the time of redemption or selling of the units. The redemption price is calculated in the following manner:

  $$\text{Redemption Price: } \frac{\text{Net Asset Value}}{(1+\text{Back end load})}$$

Contingent Deferred Sales Charges (CDSC): This is a back end load paid when the units are redeemed during the initial of ownership. As per the SEBI (Mutual Fund) Regulations, 1996 CDSC may only be charged for the first four years after purchase of the units. The regulations also provide for the maximum CDSC that can be charged in a particular year. The front end and back end loads cannot be in excess of 7%

Limitations of fees & expenses on issue of schemes as per the Regulations:

- AMC's expenses to be clearly identified and appropriated to the individual schemes and to be disclosed the in the offer document. The advisory fees of the AMC shall be the following:
  - One and a quarter of one per cent of the weekly average net assets outstanding in each accounting year for the scheme concerned, as long as the net assets do not exceed Rs.100 crores, and
  - One per cent of the excess amount over Rs.100 crores, where net assets so calculated exceed Rs.100 crores.
- in case of an index fund scheme, the investment and advisory fees shall not exceed three fourths of one percent (0.75%) of the weekly average net assets
- For schemes launched on a no load basis, the asset management company shall be entitled to collect an additional management fee not exceeding 1% of the weekly average net assets outstanding in each financial year
- AMC may charge recurring expenses in addition to the above expenses
- The total expenses of the scheme excluding issue or redemption expenses, including the investment management and advisory fee shall be subject to the following limits (with certain exceptions for specific funds) :—
  - *(i)* On the first Rs.100 crores of the average weekly net assets 2.5%;
  - *(ii)* On the next Rs.300 crores of the average weekly net assets 2.25%;
  - *(iii)* On the next Rs.300 crores of the average weekly net assets 2.0%;
  - *(iv)* On the balance of the assets 1.75%

Computation of Returns: Investors' returns are of three types

- Cash Dividend
- Capital Gains disbursement
- Changes in the fund's NAV per unit (Unrealized Capital Gain)

Thus returns are calculated in the following manner:

$R = D + CG + UCG \times 100$

or; $R = D + CG + (NAV_1 – NAV_0)/ NAV_0 \times 100$

Where;

R = returns
D = Dividend
CG = Capital Gains
UCG = Unrealized Capital Gain
= $(NAV_1 – NAV_0)/ NAV_0$
NAV_1 = Net Asset Value at the end of period 1
NAV_0 = Net Asset Value at the end of period 0

Classification of Mutual Funds: On the basis of

- **Function –** Mutual Funds can be divided into
  - **Open Ended Scheme –** In such schemes investors can make an entry or exit in the fund anytime. The capital of the fund is unlimited and the redemption period is undefined
  - **Close Ended Scheme –** In this case the investor can buy the units only during Initial Public Offer or after the units have been listed. The scheme has limited life and at the end of the period the corpus is liquidated. Investors can exit the scheme by a) selling shares in the stock market, b) expiry of the scheme and c) during repurchase period

Difference between Open ended and Close ended Scheme:

	Close Ended Scheme	**Open Ended Scheme**
1	Fixed Corpus: no new units can be offered beyond the limit time	Variable Corpus due to ongoing purchase and redemption
2	Listed on the stock exchange for buying and selling, other than equity linked savings scheme	No listing; transaction done directly with the fund
3	Two values are available NAV and market trading price	One price available – NAV
4	Mostly liquid	Highly liquid

- **Portfolio**
  - **Equity –** Funds that invest in equity stocks. Depending on the kind of investor and his risk appetite, the funds are of the following types
    - growth funds – for long term investors looking for long term capital appreciation
    - aggressive funds – for investors looking for super normal profits, investments are in start-ups, IPOs, speculative shares

        - Income Funds – for investors looking for safe stocks with high cash dividends
        - Balance Funds – mix of growth and income funds
    - **Debt –**
        - Bond funds – investments are in fixed income securities
        - Gilt funds – investments in G-secs
    - **Special Funds**
        - Index funds – investments in stock index, the benefit of investing in index funds is that the investor is immune to the upward and downward movement of a particular stock/ script
        - International Funds – Mutual Fund locate in India, raising money in India for investments to be made globally
        - Offshore funds – Mutual Fund located in India, raises money globally to be invested in India
        - Sector Funds – investing in a particular industry
- **Ownership**
    - Public Sector Mutual Funds – sponsored by a company of public sector
    - Private Sector Mutual Funds – sponsored by company of private sector
    - Foreign Mutual Funds – sponsored by foreign companies operating in India

Types of Mutual Funds:

- Balanced Funds – A portfolio which has strategic allocation of debt and equity
- Equity diversified funds – As the name suggests the portfolio has wide array of stocks. There are many types of equity dividend funds:
    - Flexicap/ Multicap funds – the fund is diversified, with defined minimum and maximum level of exposure to each of the market caps
    - Contra Fund – it is for those investors who want the fund to perform in all types of market environments
    - Index Fund – fund that tracks the performance of the benchmark market index
    - Dividend Yield Fund – as the name suggests the fund invests in shares of companies having high dividend yield. These stocks are generally less volatile and offer potential for good capital appreciation
- Equity Linked Tax Savings Scheme (ELSS) – this fund gives investors the option to save taxes under section 80C of the Income Tax Act. The fund has a minimum lock in of 3 years, it helps investors avoid problems of investing lumpsum amount and also helps one get the benefit of averaging
- Sector Funds – as the name suggests, the fund invests in a particular sector to let investors reap benefit of seasonal returns and industry cycles. These would be riskier than diversified portfolios as they bear a greater risk of a particular sector turning out to be non performing
- Thematic Funds – The fund managers invest in a particular sector or industry which is likely to out perform, based on their assessment or industry analysis. The

downside of investing in such funds is that one has to rely on the fund managers research and analysis.

- Arbitrage Funds – these funds provide safety, liquidity, better returns and tax benefits as these funds include mix of derivatives and equity. These funds provide better returns than a typical debt instrument and lower volatility than equity
- Hedge Funds – There are no hedge funds in India but they are private investment vehicles and are lightly regulated investment funds. The concept is later explained in details
- Cash Funds – As the name suggests these funds offer higher liquidity and lower volatility as the portfolio includes debt and money market instruments
- Exchange Traded Funds – these funds are listed on the stock exchange and their prices are linked to the underlying index. The concept has been explained in detail later

Factors to be considered for selecting Mutual Fund:

- Past performance – The past performance of the mutual fund can be adjudged by growth of the NAV during the referral period. Growth is evaluated in the following manner:

$$\text{Growth} = (NAV_1 - NAV_0) + D_1 / NAV_0$$

- Timing – timing for investments made by the mutual fund is critical for maximizing returns, for instance investing in the bullish or bearish market may be vital for the investment and performance of the mutual fund
- Size of fund – larger the size of the fund, greater would be the risk as there would be more products to be monitored. Small sized funds may not give the much expected return or growth. So investors should be very careful will selecting the fund to invest in.
- Age of fund – Longevity of the fund would indicated how seasoned the player is in the market and expertise.
- Fund Manager – He is the fulcrum of the fund, the investors should also have an idea whose hands their money rests in.
- Expense Ratio – Though there is an upper ceiling imposed on the expenses by the regulators. Lower the expenses higher would be the return
- PE Ratio – The weighted average PE of the stocks in the portfolio can be used to measure the risk levels of the fund
- Portfolio turnover – This again is crucial to the return bearing capacity of the fund. High turnover would have greater cost implications, whereas low turnover would mean that the fund manager is not using the market options to the hilt

Short notes on:

Money Market Mutual Funds (MMMFs) – These are funds that invest in money market instruments. The purpose of such funds was to enable the individual investors to gain from investments in money market instruments which would have not been possible otherwise for individuals to invest in. MMMFs have a minimum lock-in period. These can be set up by scheduled commercial banks, public financial institutions or their subsidiaries and can be both open ended or close ended schemes. Banks can also set up ‘in-house’ MMMFs wherein the assets and liabilities would be ring fenced or allocated to a separate entity, such as a trust. The units of MMMFs can be issued to individuals only. Non-resident Indian individuals may subscribe provided the capital and the dividend would be non-repartiable. MMMFs are free to determine the investment by a single investor. Prior compulsory authorization from RBI is required before setting up MMMFs. Issue or transfer of units would attract stamp duty. Switching of assets between schemes can be done at market rate and based upon conscious investment decisions.

Exchange Traded Funds (ETFs) – They are hybrid products with features of an index fund. These funds are listed on the stock exchange and their prices are linked to the underlying index. Exchange traded funds trade like a stock. Unlike mutual funds which have their Net Asset Value (NAV) calculated at the end of each trading day, an exchange traded funds price changes throughout the day with variation in demand and supply. These exchange traded funds can be traded like stocks. ETFs provide the diversification of index funds and flexibility of a stock. Expense ratio of ETFs is lower than that of an average mutual fund

Hedge Funds - Hedge funds are private pooled investment limited partnerships which fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. The term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships. These funds are exempted from many of the rules and regulations governing mutual funds. Hedge funds are not required to meet disclosure requirements and are prohibited from public advertising and soliciting investors directly or through a registered broker-dealer. They provide flexibility in their investment options. Hedge funds can use short selling, leverage and derivatives. This enables them to deliver non-market correlated returns. They also provide a wide dispersion in investment returns, volatility and risk.