2.MUTUAL FUNDS - EXPLAINED

1A.Discover the Origins of Mutual Fund Investing in U.S.A

When three Boston securities executives pooled their money together in 1924 to create the first mutual fund, they had no idea how popular mutual funds would become.
The idea of pooling money together for investing purposes started in Europe in the mid-1800s. The first pooled fund in the U.S. was created in 1893 for the faculty and staff of Harvard University. On March 21st, 1924 the first official mutual fund was born. It was called the Massachusetts Investors Trust.
After one year, the Massachusetts Investors Trust grew from $50,000 in assets in 1924 to $392,000 in assets (with around 200 shareholders).
In contrast, there are over 10,000 mutual funds in the U.S. today totaling around $7 trillion (with approximately 83 million individual investors) according to the Investment Company Institute.

The stock market crash of 1929 slowed the growth of mutual funds. In response to the stock market crash, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws require that a fund be registered with the SEC and provide prospective investors with a prospectus. The SEC (U.S. Securities and Exchange Commission) helped create the Investment Company Act of 1940 which provides the guidelines that all funds must comply with today.

With renewed confidence in the stock market, mutual funds began to blossom. By the end of the 1960s there were around 270 funds with $48 billion in assets.

In 1976, John C. Bogle opened the first retail index fund called the First Index Investment Trust. It is now called the Vanguard 500 Index fund and in November of 2000 it became the largest mutual fund ever with $100 billion in assets.

One of the largest contributors of mutual fund growth was Individual Retirement Account (IRA) provisions made in 1981, allowing individuals (including those already in corporate pension plans) to contribute $2,000 a year. Mutual funds are now popular in employer-sponsored defined contribution retirement plans (401k), IRAs and Roth IRAs.

Mutual funds are very popular today, known for ease-of-use, liquidity, and unique diversification capabilities.

1B.Mutual Fund History India

Unit Trust of India(UTI) was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up **mutual funds**. UTI has an extensive marketing network of over 40,000 agents all over the country.

In the year 1992, **Securities and exchange Board of India (SEBI) Act** was passed. The objectives of SEBI are − to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

In 1995, the RBI permitted private sector institutions to set up Money Market Mutual Funds (MMMFs). They can invest in treasury bills, call and notice money, commercial paper, commercial bills accepted/ co-accepted by banks, certificates of deposit and dated government securities having unexpired

maturity upto one year.

As far as mutual funds are concerned, SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All **mutual funds** whether promoted by public sector or private sector entities including those promoted by foreign entities are **governed by the same set of Regulations**. There is no distinction in regulatory requirements for these **mutual funds** and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

II. Different Types Of Funds

No matter what type of investor you are, there is bound to be a mutual fund that fits your style. According to the last count there are more than 10,000 mutual funds in North America! That means there are more mutual funds than stocks.

It's important to understand that each mutual fund has different risks and rewards. In general, the higher the potential return, the higher the risk of loss. Although some funds are less risky than others, all funds have some level of risk - it's never possible to diversify away all risk. This is a fact for all investments.

Each fund has a predetermined investment objective that tailors the fund's assets, regions of investments and investment strategies. At the fundamental level, there are three varieties of mutual funds:

1) Equity funds (stocks)

2) Fixed-income funds (bonds)

3) Money market funds

All mutual funds are variations of these three asset classes. For example, while equity funds that invest in fast-growing companies are known as growth funds, equity funds that invest only in companies of the same sector or region are known as specialty funds.

Let's go over the many different flavors of funds. We'll start with the safest and then work through to the more risky.

Money Market Funds

The money market consists of short-term debt instruments, mostly Treasury bills. This is a safe place to park your money. You won't get great returns, but you won't have to worry about losing your principal. A typical return is twice the amount you would earn in a regular checking/savings account and a little less than the average certificate of deposit (CD).

Bond / Income Funds

Income funds are named appropriately: their purpose is to provide current income on a steady basis.

When referring to mutual funds, the terms "fixed-income," "bond," and "income" are synonymous. These terms denote funds that invest primarily in government and corporate debt. While fund holdings may appreciate in value, the primary objective of these funds is to provide a steady cashflow to investors. As such, the audience for these funds consists of conservative investors and retirees.

Bond funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds aren't without risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much more risky than a fund that invests in government securities. Furthermore, nearly all bond funds are subject to interest rate risk, which means that if rates go up the value of the fund goes down.

Balanced Funds

The objective of these funds is to provide a balanced mixture of safety, income and capital appreciation. The strategy of balanced funds is to invest in a combination of fixed income and equities. A typical balanced fund might have a weighting of 60% equity and 40% fixed income. The weighting might also be restricted to a specified maximum or minimum for each asset class.

A similar type of fund is known as an asset allocation fund. Objectives are similar to those of a balanced fund, but these kinds of funds typically do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as the economy moves through the business cycle.

Equity Funds

Funds that invest in stocks represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth with some income. There are, however, many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below.

	Investment Style		
Size	Value	Blend	Growth
Large			
Mid			
Small			

The idea is to classify funds based on both the size of the companies invested in and the investment style of the manager. The term value refers to a style of investing that looks for high quality companies that are out of favor with the market. These companies are characterized by low P/E and price-to-book ratios and high dividend yields. The opposite of value is growth, which refers to companies that have had (and are expected to continue to have) strong growth in earnings, sales and cash flow. A compromise between value and growth is blend, which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

For example, a mutual fund that invests in large-cap companies that are in strong financial shape but

have recently seen their share prices fall would be placed in the upper left quadrant of the style box (large and value). The opposite of this would be a fund that invests in startup technology companies with excellent growth prospects. Such a mutual fund would reside in the bottom right quadrant (small and growth).

Global / International Funds

An international fund (or foreign fund) invests only outside your home country. Global funds invest anywhere around the world, including your home country.

It's tough to classify these funds as either riskier or safer than domestic investments. They do tend to be more volatile and have unique country and/or political risks. But, on the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification. Although the world's economies are becoming more inter-related, it is likely that another economy somewhere is outperforming the economy of your home country.

Specialty Funds

This classification of mutual funds is more of an all-encompassing category that consists of funds that have proved to be popular but don't necessarily belong to the categories we've described so far. This type of mutual fund forgoes broad diversification to concentrate on a certain segment of the economy.

Sector funds are targeted at specific sectors of the economy such as financial, technology, health, etc. Sector funds are extremely volatile. There is a greater possibility of big gains, but you have to accept that your sector may tank.

Regional funds make it easier to focus on a specific area of the world. This may mean focusing on a region (say Latin America) or an individual country (for example, only Brazil). An advantage of these funds is that they make it easier to buy stock in foreign countries, which is otherwise difficult and expensive. Just like for sector funds, you have to accept the high risk of loss, which occurs if the region goes into a bad recession.

Socially-responsible funds (or ethical funds) invest only in companies that meet the criteria of certain guidelines or beliefs. Most socially responsible funds don't invest in industries such as tobacco, alcoholic beverages, weapons or nuclear power. The idea is to get a competitive performance while still maintaining a healthy conscience.

Index Funds

The last but certainly not the least important are index funds. This type of mutual fund replicates the performance of a broad market index such as the S&P 500 or Dow Jones Industrial Average (DJIA). An investor in an index fund figures that most managers can't beat the market. An index fund merely replicates the market return and benefits investors in the form of low fees.

Schemes according to Maturity Period:

A mutual fund scheme can be classified into **open-ended** scheme or **close-ended** scheme depending on its maturity period.

Open-ended Fund

An **open-ended Mutual fund** is one that is available for subscription and repurchase on a continuous basis. These Funds do not have a **fixed maturity period**. Investors can conveniently buy and sell units at **Net Asset Value (NAV)** related prices which are declared on a daily basis. The key feature

of open-end schemes is liquidity.

Close-ended Fund

A close-ended Mutual 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.

Fund according to Investment Objective:

A scheme can also be classified as growth fund, income fund, or balanced fund 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 Scheme

The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest 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 Scheme

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments. Such funds 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 Fund

The aim of balanced funds is to 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 Fund

These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

Gilt Fund

These 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.

Index Funds

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 weightage comprising of an 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. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme. There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges.

The Costs

Costs are the biggest problem with mutual funds. These costs eat into your return, and they are the main reason why the majority of funds end up with sub-par performance.

What's even more disturbing is the way the fund industry hides costs through a layer of financial complexity and jargon. Some critics of the industry say that mutual fund companies get away with the fees they charge only because the average investor does not understand what he/she is paying for.

Fees can be broken down into two categories:

1. Ongoing yearly fees to keep you invested in the fund.

2. Transaction fees paid when you buy or sell shares in a fund (loads).

The Expense Ratio

The ongoing expenses of a mutual fund is represented by the expense ratio. This is sometimes also referred to as the management expense ratio (MER). The expense ratio is composed of the following:

• The cost of hiring the fund manager(s) - Also known as the management fee, this cost is between 0.5% and 1% of assets on average. While it sounds small, this fee ensures that mutual fund managers remain in the country's top echelon of earners. Think about it for a second: 1% of 250 million (a small mutual fund) is $2.5 million - fund managers are definitely not going hungry! It's true that paying managers is a necessary fee, but don't think that a high fee assures superior performance.

• Administrative costs - These include necessities such as postage, record keeping, customer service, cappuccino machines, etc. Some funds are excellent at minimizing these costs while others (the ones with the cappuccino machines in the office) are not.

• The last part of the ongoing fee (in the United States anyway) is known as the 12B-1 fee. This expense goes toward paying brokerage commissions and toward advertising and promoting the fund. That's right, if you invest in a fund with a 12B-1 fee, you are paying for the fund to run commercials and sell itself!

On the whole, expense ratios range from as low as 0.2% (usually for index funds) to as high as 2%. The average equity mutual fund charges around 1.3%-1.5%. You'll generally pay more for specialty or international funds, which require more expertise from managers.

Are high fees worth it? You get what you pay for, right?

Wrong.

Just about every study ever done has shown no correlation between high expense ratios and high returns. This is a fact. If you want more evidence, consider this quote from the Securities and Exchange Commission's website:

"Higher expense funds do not, on average, perform better than lower expense funds."

Loads, A.K.A. "Fee for Salesperson"

Loads are just fees that a fund uses to compensate brokers or other salespeople for selling you the mutual fund. All you really need to know about loads is this: don't buy funds with loads.

In case you are still curious, here is how certain loads work:

• Front-end loads - These are the most simple type of load: you pay the fee when you purchase the fund. If you invest $1,000 in a mutual fund with a 5% front-end load, $50 will pay for the sales charge, and $950 will be invested in the fund.

• Back-end loads (also known as deferred sales charges) - These are a bit more complicated. In such a fund you pay the a back-end load if you sell a fund within a certain time frame. A typical example is a 6% back-end load that decreases to 0% in the seventh year. The load is 6% if you sell in the first year, 5% in the second year, etc. If you don't sell the mutual fund until the seventh year, you don't have to pay the back-end load at all.

A no-load fund sells its shares without a commission or sales charge. Some in the mutual fund industry will tell you that the load is the fee that pays for the service of a broker choosing the correct fund for you. According to this argument, your returns *will* be higher because the professional advice put you into a better fund. There is little to no evidence that shows a correlation between load funds and superior performance. In fact, when you take the fees into account, the average load fund performs worse than a no-load fund.

Picking A Mutual Fund

Buying and Selling

You can buy some mutual funds (no-load) by contacting the fund companies directly. Other funds are sold through brokers, banks, financial planners, or insurance agents. If you buy through a third party there is a good chance they'll hit you with a sales charge (load).

That being said, more and more funds can be purchased through no-transaction fee programs that offer funds of many companies. Sometimes referred to as a "fund supermarket," this service lets you consolidate your holdings and record keeping, and it still allows you to buy funds without sales charges from many different companies. Popular examples are Schwab's OneSource, Vanguard's FundAccess, and Fidelity's FundsNetwork. Many large brokerages have similar offerings.

Selling a fund is as easy as purchasing one. All mutual funds will redeem (buy back) your shares on any business day. In the United States, companies must send you the payment within seven days.

The Value of Your Fund

Net asset value (NAV), which is a fund's assets minus liabilities, is the value of a mutual fund. NAV per share is the value of one share in the mutual fund, and it is the number that is quoted in newspapers. You can basically just think of NAV per share as the price of a mutual fund. It fluctuates everyday as fund holdings and shares outstanding change.
When you buy shares, you pay the current NAV per share plus any sales front-end load. When you sell your shares, the fund will pay you NAV less any back-end load.

How To Read A Mutual Fund Table

52W high	52W low	Fund	Spec.	Fri. NAVPS $chg	Fri. NAVPS %chg	Wkly NAVPS high	Wkly NAVPS low	Wkly NAVPS cls	Wkly NAVPS $chg	Wkly NAVPS %chg
Montrusco Bolton Funds										
11.71	10.12	Bal Plus	*N	-0.08	-0.76	10.58	10.50	10.50	0.02	0.15
12.50	10.25	Growth Plus	*N	-0.10	-0.96	10.89	10.78	10.78	0.02	0.22
31.39	24.78	Quebec Growth	*FR	0.05	0.17	26.97	26.75	26.97	0.43	1.61
13.78	7.24	RSP Intl Growth	*N	-0.08	-1.01	7.45	7.36	7.36	-0.03	-0.41
11.16	9.09	Value Plus	*N	-0.07	-0.75	9.39	9.32	9.32	0.01	0.14
9.65	8.90	World Inc	*N	-0.04	-0.40	9.52	9.39	9.48	0.04	0.43
Montrusco Select Funds CS(n)										
12.87	10.49	Balanced	*N	-0.04	-0.37	10.85	10.80	10.81	0.05	0.45
16.32	12.11	Balanced +	*N	-0.05	-0.43	12.57	12.52	12.52	0.06	0.45
10.36	9.86	Bond Index +	X*N	-0.03	-0.32	10.35	10.30	10.30	0.04	0.37
Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9	Column 10	Column 11

Columns 1 & 2: 52-Week Hi and Low - These show the highest and lowest prices the mutual fund has experienced over the previous 52 weeks (one year). This typically does not include the previous day's price.

Column 3: Fund Name - This column lists the name of the mutual fund. The company that manages the fund is written above in bold type.

Column 4: Fund Specifics - Different letters and symbols have various meanings. For example, "N" means no load, "F" is front end load, and "B" means the fund has both front and back-end fees. For other symbols see the legend in the newspaper in which you found the table.

Column 5: Dollar Change -Thisstates the dollar change in the price of the mutual fund from the previous day's trading.

Column 6: % Change - This states the percentage change in the price of the mutual fund from the previous day's trading.

Column 7: Week High - This is thehighest price the fund traded at during the past week.

Column 8: Week Low - This is thelowest price the fund traded at during the past week.

Column 9: Close - The last price at which the fund was traded is shown in this column.

Column 10: Week's Dollar Change - This represents the dollar change in the price of the mutual fund from the previous week.

Column 11: Week's % Change - This shows the percentage change in the price of the mutual fund from the previous week.

Don't Be Fooled By Mutual Fund Ads

I'm sure you've noticed all those mutual fund ads that quote their amazingly high one-year rates of return. Your first thought is "wow, that mutual fund did great!" Well, yes it did great last year, but then you look at the three-year performance, which is lower, and the five year, which is yet even lower. What's the underlying story here? Let's look at a real example. These figures came from a local paper:

1 year	3 year	5 year
53%	20%	11%

Last year, the fund had excellent performance at 53%. But in the past three years the average annual return was 20%. What did it do in years 1 and 2 to bring the average return down to 20%? Some simple math shows us that the fund made an average return of 3.5% over those first two years: 20% = (53% + 3.5% + 3.5%)/3. Because that is only an average, it is very possible that the fund lost money in one of those years.

It gets worse when we look at the five-year performance. We know that in the last year the fund returned 53% and in years 2 and 3 we are guessing it returned around 3.5%. So what happened in years 4 and 5 to bring the average return down to 11%? Again, by doing some simple calculations we find that the fund must have lost money, an average of -2.5% each year of those two years: 11% = (53% + 3.5% + 3.5% - 2.5% - 2.5%)/5. Now the fund's performance doesn't look so good!

It should be mentioned that, for the sake of simplicity, this example, besides making some big assumptions, doesn't include calculating compound interest. Still, the point wasn't to be technically accurate but to demonstrate how misleading mutual fund ads can be. A fund that loses money for a few years can bump the average up significantly with one or two strong years.

Conclusion

Let's recap what we've learned in this tutorial:

- A mutual fund brings together a group of people and invests their money in stocks, bonds, and other securities.
- The advantages of mutuals are professional management, diversification, economies of scale, simplicity and liquidity.
- The disadvantages of mutuals are high costs, over-diversification, possible tax consequences, and the inability of management to guarantee a superior return.
- There are many, many types of mutual funds. You can classify funds based on asset class, investing strategy, region, etc.
- Mutual funds have lots of costs.
- Costs can be broken down into ongoing fees (represented by the expense ratio) and transaction fees (loads).
- The biggest problems with mutual funds are their costs and fees.
- Mutual funds are easy to buy and sell. You can either buy them directly from the fund company

or through a third party.
- Mutual fund ads can be very deceiving.