5. How does Mutual fund works

PRICING AND VALUATION Description. The value of the shares of an open-end mutual fund is readily determined. Each day, the accounting staff of a fund simply adds up the value of all the securities in the portfolio, adds in other assets, deducts **liabilities**, and comes up with a net overall value. It is then a simple matter to divide the **net assets** by the number of shares outstanding. This is called the **net asset value**, and is the price at which investors buy and sell shares from the fund. The net asset value is listed in the financial section of many major newspapers.

How it Works. Let's look at a simplified example. Suppose we start a brand-new fund, the We Fly Higher Stock Fund.

On its first day of operation, the We Fly Higher Stock Fund (which I'll refer to as WFHSF, for short) receives $100 from John Smith. At $10.00 per share, Mr. Smith receives ten shares. (At the start, the fund's starting share price-in this case, $10.00 per share -- is arbitrary and set by the Fund.) The result of the transaction? The assets of the Fund are $100 in cash, and there are ten shares outstanding. Divide $100 in assets by 10 shares to get $10.00 per share.

On day two, WFHSF buys two shares of Amalgamated Fish & Chips, a seafood and technology company, for $50 each. We still have a per share value in WFHSF of $10.00, because the total assets of the fund are still worth $100 (2 shares of Amalgamated at $50.00 each), and there are still ten shares of the fund outstanding. However, from this point on, the share value in the Fund will vary, and will no longer be arbitrary. Federal regulations require a daily re-valuation process, called **marking-to-market**, of all open-end mutual funds. Marking to market refers to adjusting the per-share price of the fund to reflect changes in the Fund's portfolio, or asset, value. In this way, investors know the true value of their investments on a daily basis, and as new investors buy into, and sell out of, the Fund, everyone gets a fair shake. With that in mind, let's see how the fluctuations in daily share prices occur, as we continue to follow the fortunes of the We Fly Higher Stock Fund.

On day three, mercury contamination (resulting from improper disposal of chip-manufacturing by-products) is found in Amalgamated's fish, and the bad news spreads rapidly. Fearing the worst, investors flock to sell Amalgamated shares, and the price of its stock plunges 50%, from $50 to $25 per share. Of course, back at the Fund, the assets have declined, too, because the Fund's assets are entirely in Amalgamated stock. The two shares the Fund holds have declined to $25 per share, as noted, and now are worth a sum total of $50. The accounting department at the Fund calculates the new value per share of the Fund by adding up all the assets, now $50.00, and dividing by ten (the number of shares outstanding), and note that each share of the Fund is now worth only $5.00. This is called the net asset value (per share is implied).

LOAD AND NO-LOAD FUNDS Description. Many people have heard the words **load** and **no-load** in connection with mutual funds, but do not understand what these terms refer to. Simply put, a load, or loaded, fund is one that has a **sales charge**. A no-load fund has no

sales charge.

How it Works. As noted above, not all funds have sales charges. Those that do simply add them on to the net asset value of the fund, thus coming up with a new, higher **offering price** per share. It is important to note that the underlying value of the fund's shares do not change; and further, that an investor selling shares will still receive only the net asset value.

Again, an example will be helpful. Let's go back to day one of the We Fly Higher Stock Fund. The beginning net asset value, or price per share, was $10.00. However, if the Fund had a 5% sales charge, shares would be priced at $10.53 to the public. Hence, the price paid per share would consist of two parts: the sales charge of $0.53 per share (5% of $10.53), and the remainder would be the net asset value ($10.53 - $0.53 = $10.00). Thus, in this example, an investor who purchased a share for $10.53 on the first day, and sold it the next day, would lose $0.53 -- the amount of the sales charge (assuming that no other changes in value occurred). Accordingly, there are two daily price listings for so-called "load" funds: the offering price (the investor's purchase price), and the net asset value (the investor's selling price). Who gets the sales charge in a load fund? Why, the salesman (or, **broker**), and his company, of course! The fund receives none of the sales charge.

A no-load fund is simpler. The net asset value is used for both the purchase price and the selling price. Therefore, the two prices are always identical.

BUYING AND SELLING FUND SHARES Description. Here we are talking about the mechanics of what an investor generally does when buying or selling shares in a mutual fund. In the case of a load fund, the broker usually takes care of the details for you. In the case of a no-load fund, investors usually deal directly with the fund in question. It is really a very simple process, and fund representatives are almost always available, through a toll-free telephone number, to help.

How it Works. Since investors in load funds (presumably) have the assistance of their brokers, we will discuss the process of buying and selling no-load funds. Many investors are a bit daunted by this process, which is unfamiliar to them. If they knew how easy it is, they wouldn't hesitate to "do it themselves"!

Once an investor knows the name of a fund that he or she has an interest in, the first task is to find the toll-free telephone number. A simple call to the fund, requesting a **prospectus** (a booklet that describes the investment--more below) and **application**, sets the process in motion. In a few days, these documents arrive in the mail. After reviewing the prospectus, the investor fills out the application, writes a check to the fund, and mails the application and check back to the fund in the enclosed envelope. That's all there is to it! Upon receipt, the fund will then open an account for the investor, purchasing as many shares as the investment dollar amount allows (fractional shares are common). Then, the fund issues periodic **statements** to the investor, detailing all transactions, including purchases, sales and **dividends**.

Selling shares is even easier than purchasing them. A simple phone call will initiate the process of the sale of shares, as directed, and money can be sent to the investor by check or wire, depending on how the account was set up. (Helpful tip: Unless you might be

tempted to spend money that is too easily available, always sign up for all of the selling options available -- that way, you can get your money more quickly, should you require it, or should you find that one or more options are unavailable when the time to sell comes.)

By the way, you can almost always add to your account, or take partial proceeds out. Most funds have a minimum beginning amount, but after that, almost anything goes in terms of additions and withdrawals (be sure to check the prospectus for details on individual fund operations procedures in this regard).

One last point. Mutual funds are heavily regulated and have proven to be trustworthy over time. You need not have trepidations about dealing through the mail with mutual funds.

FUND OBJECTIVES AND THE PROSPECTUS Description. We have learned that mutual funds are investment companies, and that they may invest in securities of various kinds, such as stocks and bonds. **Money market** mutual funds, which constitute a major portion of the fund universe, invest only in very short-term bonds. A fund's objective, described in the prospectus, gives broad indications of the types of investments a fund may make. The prospectus discloses important specific details about the fund that the prospective investor should be aware of, including allowable investments, expenses, risks, and financial statements. Therefore, ***investors should always read the prospectus carefully before investing or sending money*!**

How it Works. The following paragraphs will give you a more in-depth view of the contents and purpose of the prospectus. The most important aspect of a fund is its investment objective. The fund's objective tells investors the goals the fund seeks to achieve, and a good deal about how it intends to achieve them. A balanced fund will generally hold stocks and bonds. A fund seeking **growth** fund will utilize stocks. A fund seeking **income** with little or no concern for growth will generally hold bonds. The objective of a fund is so fundamental that it generally determines the category into which a fund will be assigned. For example, we speak of growth funds, foreign funds, income funds, and money-market funds. The stated objective is usually quite short, one or two paragraphs in length, and can be found in the very beginning of the fund's prospectus.

Listed below are some examples of major objective categories:

- **Investment Objective:**
  - Preservation of Capital & Liquidity--Achieved by investing in very short-term bonds
  - Income--Achieved by investing in bonds
  - Balanced--Achieved by investing in bonds and stocks
  - Growth--Achieved by investing in stocks

Immediately following the investment objective in the prospectus is a discussion of what investments are allowed, and in what percentages. Fully diversified stock funds, for

example, must conform to legal limits for maximum holdings in any one stock or **industry**. (Specifically, a diversified fund, as defined in the **Investment Company** Act of 1940, with respect to 75% of its assets, may hold no more than 5% in any one company, and not more than 10% of any firm's outstanding shares. The vast majority of mutual funds meet these conditions.) On the other end of the spectrum are **sector** funds, which may hold stocks from a single industry only. Risks of the various allowed investments are discussed in considerable detail in prospectuses, although it is at this point in reading the prospectus that many investors get "bogged down" in the legal verbiage and technical detail.

Although the prospectus is the investor's first line of defense, and should be examined carefully, it does not disclose everything that an investor may want to know before investing in a given fund. Further, it gives information in a way that makes comparison between funds difficult. As a result of the demand for easier-to-use and more complete information, we have witnessed a proliferation of mutual fund guides and newsletters in the past ten years. **Morningstar**, a relative newcomer to the fund scene, has become the dominant, independent provider of mutual fund information. They achieved their remarkable success in the market for fund information by providing comprehensive data that was previously difficult to obtain, and they did it in a manner that was timely and made comparisons of funds relatively easy. Examples of information that Morningstar and other, competitive services include are: manager's name and tenure, major individual investment holdings, overall portfolio characteristics (such as amount of stock in various industries, bond credit ratings, etc.), and performance information that is easily compared, on an apples-with-apples basis, with other funds and with **indices**. For example, the fund's performance will be compared on a chart with other, similar funds, and with comparable indices of similar investments (i.e., a foreign fund's performance will be compared to the performance of foreign stocks, in general). In my opinion, no mutual fund investor should be without a high-quality fund reference guide, such as Morningstar or the **No-Load Fund Analyst**, to supplement the basic information found in the prospectus.

ADVANTAGES AND DISADVANTAGES OF MUTUAL FUNDS Description. The primary advantages of mutual funds are summed up in an oft-heard litany: diversification, professional management and convenience. By and large, most funds do achieve this basic mission. Over and above that, funds offer lower costs by virtue of their size; they may receive breaks on **trading** costs, and they certainly spread many internal costs over a large **6** base, allowing for **economies of scale**. On the negative side, funds make tax planning difficult (because the timing of taxable **distributions** is uncertain), and may be somewhat difficult to track in terms of what they actually are investing in (which is generally not disclosed until after the fact for competitive reasons). In addition, so-called non-substantial changes in the way the funds are managed (such as manager switches) may not be disclosed to investors by fund companies in a timely manner.

How it Works. Diversification is a tremendous benefit of mutual funds. For a low minimum investment, in most cases, an investor can own hundreds or thousands of individual security issues through a single fund, and thus spread risk over a substantially broader base. Taking things one step further, different types of funds allow participation in many types of securities, such as foreign stocks, foreign bonds, real estate securities, technology stocks, small companies, and so on. Thus, a single investor can assemble a portfolio of mutual funds that invest in different asset classes. The chance of any single person being sufficiently well-versed to manage such diverse investments is highly unlikely, even if done

full-time! In the extreme, funds may even own other mutual funds, resulting in a virtual all-in-one portfolio. An example of the all-in-one, "fund of funds" approach would be Vanguard's Star Fund. The Star Fund invests in about eight other Vanguard funds with different **objectives** -- small stock, blue chip stock, bonds, etc. -- with no additional expenses added onto the low expenses of the underlying funds. Such a fund might serve as an entire investment portfolio for the small investor.

The second potential benefit, professional management, is always guaranteed, but sadly, only because managers of funds are paid for their services. Fortunately, truly dismal mutual fund management is rare (I can think of only a handful of cases where investment returns have badly trailed the relevant market measures over substantial periods of time). Finally, there is no doubt that investors benefit from substantial convenience by investing in mutual funds. They are relieved of the day-to-day tasks involved in researching, buying and selling securities. In the case of individual securities, day-to-day vigilance is a virtual requirement, especially in a diversified portfolio, with many holdings. Mutual funds, on the other hand, need not be looked at on a daily, weekly or even monthly basis. Occasional reviews, perhaps once a year, will suffice. (Helpful Hint: the same guidelines and practices for picking a mutual fund in the first place are also useful for fund reviews.)

Perhaps the biggest negative aspect of mutual funds is tax-planning difficulty and uncertainty. Funds make taxable distributions in a largely hard-to-foresee manner. In addition, they are required to distribute long-term capital gains in the year realized; thus the investor loses control over the timing of the realization and taxation of capital gains, contrary to the situation where an investor who owns securities outright, can choose sale dates.

Reference sites
http://www.mutualfundsindia.com/
http://www.amfiindia.com/
to know nav : http://www.amfiindia.com/navreport.asp