1B.BASICS OF MUTUAL FUNDS IN INDIA

Basics of Mutual Funds	Working of Mutual Funds	Regulatory Authorities	What is a Mutual Fund?
Diversification	Types of Mutual Funds Schemes	Types of returns	Pros & Cons

Basics of mutual funds

The article mentioned below, is for the investors who have not yet started investing in mutual funds, but willing to explore the opportunity and also for those who want to clear their basics for what is mutual fund and how best it can serve as an investment tool.

Getting Started

Before we move to explain what is mutual fund, it's very important to know the area in which mutual funds works, the basic understanding of stocks and bonds.

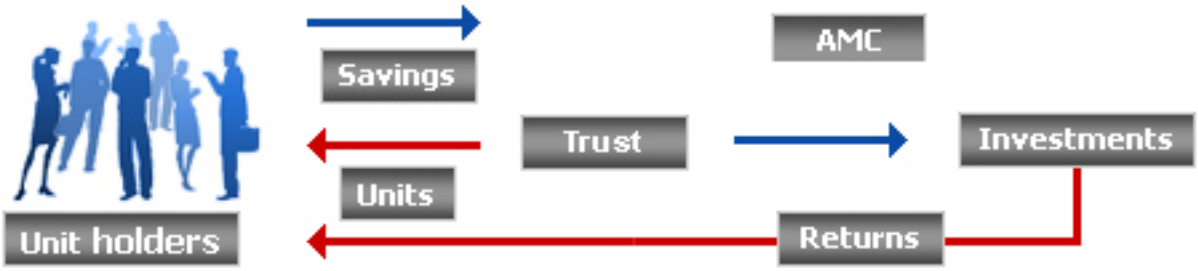
Stocks

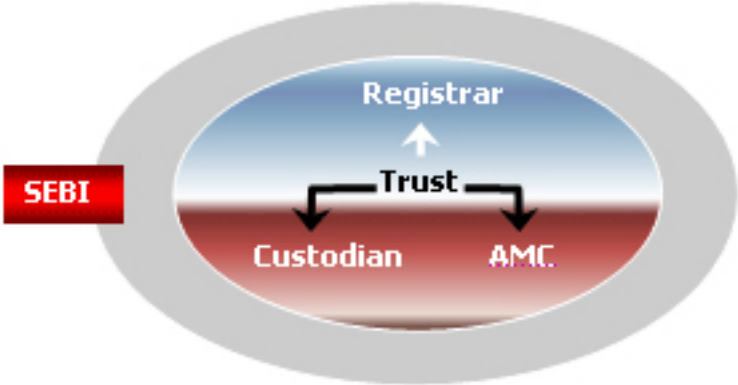
Stocks represent shares of ownership in a public company. Examples of public companies include Reliance, ONGC and Infosys. Stocks are considered to be the most common owned investment traded on the market.

Bonds

Bonds are basically the money which you lend to the government or a company, and in return you can receive interest on your invested amount, which is back over predetermined amounts of time. Bonds are considered to be the most common lending investment traded on the market.
There are many other types of investments other than stocks and bonds (including annuities, real estate, and precious metals), but the majority of mutual funds invest in stocks and/or bonds.

Working of Mutual Fund





Regulatory Authorities

To protect the interest of the investors, SEBI formulates policies and regulates the mutual funds. It notified regulations in 1993 (fully revised in 1996) and issues guidelines from time to time. MF either promoted by public or by private sector entities including one promoted by foreign entities is governed by these Regulations.

SEBI approved Asset Management Company (AMC) manages the funds by making investments in various types of securities. Custodian, registered with SEBI, holds the securities of various schemes of the fund in its custody.

According to SEBI Regulations, two thirds of the directors of Trustee Company or board of trustees must be independent.
The Association of Mutual Funds in India (AMFI) reassures the investors in units of mutual funds that the mutual funds function within the strict regulatory framework. Its objective is to increase public awareness of the mutual fund industry.

AMFI also is engaged in upgrading professional standards and in promoting best industry practices in diverse areas such as valuation, disclosure, transparency etc.

Diversification

Diversification is nothing but spreading out your money across available or different types of investments. By choosing to diversify respective investment holdings reduces risk tremendously up to certain extent.

The most basic level of diversification is to buy multiple stocks rather than just one stock. Mutual funds are set up to buy many stocks. Beyond that, you can diversify even more by purchasing different kinds of stocks, then adding bonds, then international, and so on. It could take you weeks to buy all these investments, but if you purchased a few mutual funds you could be done in a few hours because mutual funds automatically diversify in a predetermined category of investments (i.e. - growth companies, emerging or mid size

companies, low-grade corporate bonds, etc).

Types of Mutual Funds Schemes in India

Wide variety of Mutual Fund Schemes exists to cater to the needs such as financial position, risk tolerance and return expectations etc. thus mutual funds has Variety of flavors, Being a collection of many stocks, an investors can go for picking a mutual fund might be easy. There are over hundreds of mutual funds scheme to choose from. It is easier to think of mutual funds in categories, mentioned below.

Overview of existing schemes existed in mutual fund category: BY STRUCTURE

1. Open - Ended Schemes:

An open-end fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. The key feature of open-end schemes is liquidity.

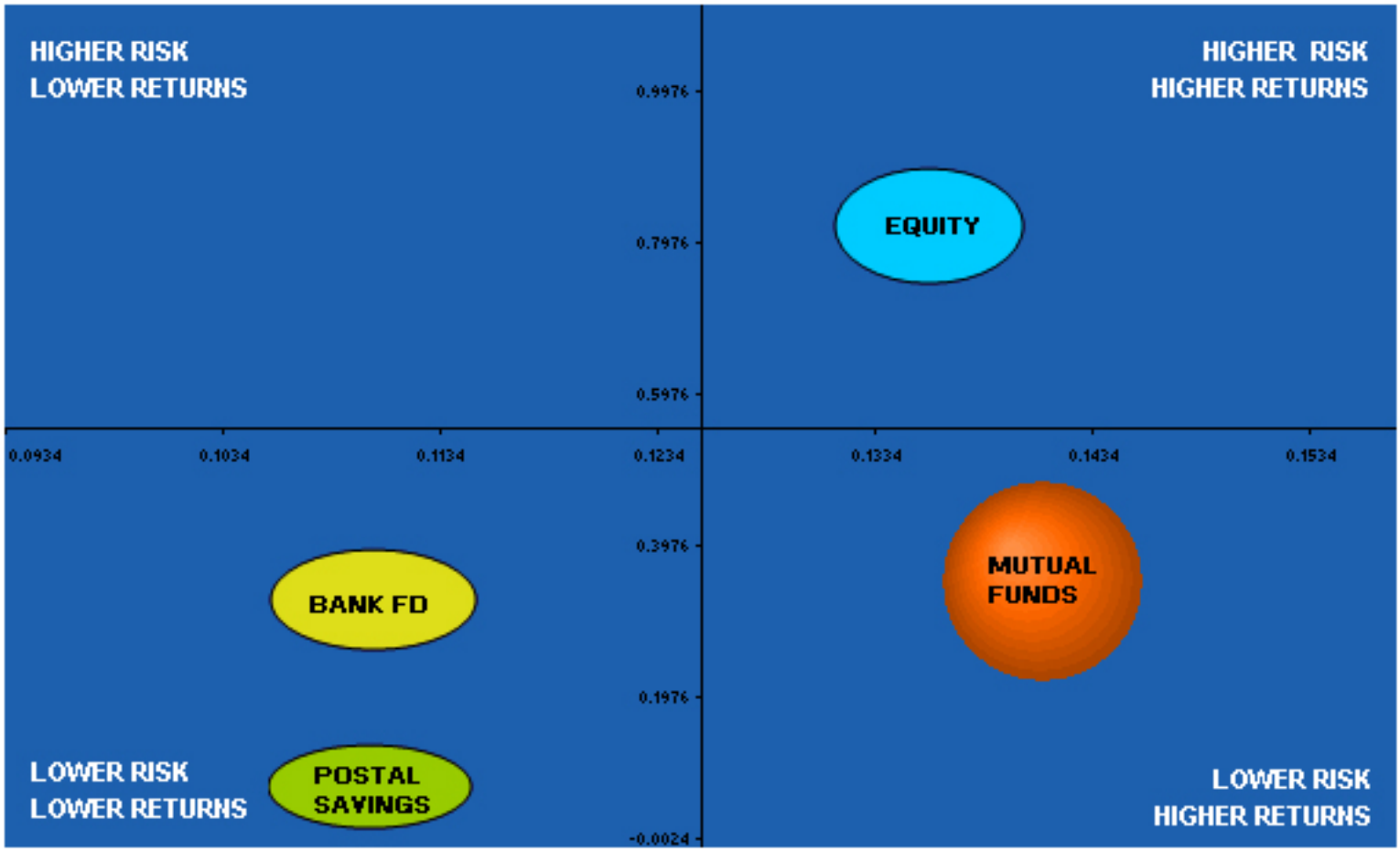
2. Close - Ended Schemes:

A closed-end fund has a stipulated maturity period which generally ranging from 3 to 15 years. The fund is open for subscription only during a specified period. 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 they 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.

3. Interval Schemes:

Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

Risk Return Matrix



The risk return trade-off indicates that if investor is willing to take higher risk then correspondingly he can expect higher returns and vise versa if he pertains to lower risk instruments, which would be satisfied by lower returns. For example, if an investors opt for bank FD, which provide moderate return with minimal risk. But as he moves ahead to invest in capital protected funds and the profit-bonds that give out more return which is slightly higher as compared to the bank deposits but the risk involved also increases in the same proportion.

Thus investors choose mutual funds as their primary means of investing, as Mutual funds provide professional management, diversification, convenience and liquidity. That doesn't mean mutual fund investments risk free. This is because the money that is pooled in are not invested only in debts funds which are less riskier but are also invested in the stock markets which involves a higher risk but can expect higher returns. Hedge fund involves a very high risk since it is mostly traded in the derivatives market which is considered very volatile.

Overview of existing schemes existed in mutual fund category: BY NATURE

1. Equity fund:

These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may vary different for different schemes and the fund manager's outlook on different stocks. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix.

2. Debt funds:

The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further classified as:

- **Gilt Funds**: Invest their corpus in securities issued by Government, popularly known as Government of India debt papers. These Funds carry zero Default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government.

- **Income Funds**: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.

- **MIPs**: Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.

- **Short Term Plans (STPs)**: Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

- **Liquid Funds**: Also known as Money Market Schemes, These funds provides easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

3. Balanced funds:

As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns.

Further the mutual funds can be broadly classified on the basis of investment parameter viz,
Each category of funds is backed by an investment philosophy, which is pre-defined in the objectives of the fund. The investor can align his own investment needs with the funds objective and invest accordingly.

By investment objective:

- **Growth Schemes:** Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.

- **Income Schemes**:Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.

- **Balanced Schemes:** Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).

- **Money Market Schemes**: Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

Other schemes

- **Tax Saving Schemes:**

Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec.88 of the Income Tax Act, as the Government offers tax incentives for investment in specified avenues. e.g. **Equity Linked Savings Schemes (ELSS).**

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

Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.

- **Sector Specific Schemes:**

These are the funds/schemes which invest in the securities of only those sectors or

industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time.

What are Load Funds / No Load Funds ?

A **Load Fund** is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the **mutual fund** for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase to the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the **performance track record and service standards** of the **mutual fund** which are more important. **Efficient Mutual funds** may give higher returns in spite of loads.

A **no-load fund** is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and **no additional charges are payable** on purchase or sale of units.

What is Assured Return Scheme?

In **Mutual Funds**, Assured Return Schemes are those schemes that assure a specific return to the unitholders irrespective of performance of the scheme.

A scheme cannot promise returns unless such returns are fully guaranteed by the sponsor or AMC and this is required to be disclosed in the offer document.

Investors should carefully read the offer document whether return is assured for the entire period of the scheme or only for a certain period. Some schemes assure returns one year at a time and they review and change it at the beginning of the next year.

Types of returns

There are three ways, where the total returns provided by mutual funds can be enjoyed by investors:

- Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all income it receives over the year to fund owners in the form of a distribution.
- If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
- If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit. Funds

will also usually give you a choice either to receive a check for distributions or to reinvest the earnings and get more shares.

Pros & cons of investing in mutual funds:

For investments in mutual fund, one must keep in mind about the Pros and cons of investments in mutual fund.

Advantages of Investing Mutual Funds:

1. Professional Management - The basic advantage of funds is that, they are professional managed, by well qualified professional. Investors purchase funds because they do not have the time or the expertise to manage their own portfolio. A mutual fund is considered to be relatively less expensive way to make and monitor their investments.

2. Diversification - Purchasing units in a mutual fund instead of buying individual stocks or bonds, the investors risk is spread out and minimized up to certain extent. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others.

3. Economies of Scale - Mutual fund buy and sell large amounts of securities at a time, thus help to reducing transaction costs, and help to bring down the average cost of the unit for their investors.

4. Liquidity - Just like an individual stock, mutual fund also allows investors to liquidate their holdings as and when they want.

5. Simplicity - Investments in mutual fund is considered to be easy, compare to other available instruments in the market, and the minimum investment is small. Most AMC also have automatic purchase plans whereby as little as Rs. 2000, where SIP start with just Rs.50 per month basis.

Disadvantages of Investing Mutual Funds:

1. Professional Management- Some funds doesn’t perform in neither the market, as their management is not dynamic enough to explore the available opportunity in the market, thus many investors debate over whether or not the so-called professionals are any better than mutual fund or investor him self, for picking up stocks.

2. Costs – The biggest source of AMC income, is generally from the entry & exit load which they charge from an investors, at the time of purchase. The mutual fund industries are thus charging extra cost under layers of jargon.

3. Dilution - Because funds have small holdings across different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.

4. Taxes - when making decisions about your money, fund managers don't consider your personal tax situation. For example, when a fund manager sells a security, a capital-gain tax is triggered, which affects how profitable the individual is from the sale. It might have been

more advantageous for the individual to defer the capital gains liability.

INVESTMENT GUIDE

Investments in Mutual Fund

Mutual Funds over the years have gained immensely in their popularity. Apart from the many advantages that investing in mutual funds provide like diversification, professional management, the ease of investment process has proved to be a major enabling factor. However, with the introduction of innovative products, the world of mutual funds nowadays has a lot to offer to its investors. With the introduction of diverse options, investors needs to choose a mutual fund that meets his risk acceptance and his risk capacity levels and has similar investment objectives as the investor.

With the plethora of schemes available in the Indian markets, an investors needs to evaluate and consider various factors before making an investment decision. Since not everyone has the time or inclination to invest and do the analysis himself, the job is best left to a professional. Since Indian economy is no more a closed market, and has started integrating with the world markets, external factors which are complex in nature affect us too. Factors such as an increase in short-term US interest rates, the hike in crude prices, or any major happening in Asian market have a deep impact on the Indian stock market. Although it is not possible for an individual investor to understand Indian companies and investing in such an environment, the process can become fairly time consuming. Mutual funds (whose fund managers are paid to understand these issues and whose Asset Management Company invests in research) provide an option of investing without getting lost in the complexities.

Most importantly, mutual funds provide risk diversification: diversification of a portfolio is amongst the primary tenets of portfolio structuring, and a necessary one to reduce the level of risk assumed by the portfolio holder. Most of us are not necessarily well qualified to apply the theories of portfolio structuring to our holdings and hence would be better off leaving that to a professional. Mutual funds represent one such option.

Lastly, Evaluate past performance, look for stability and although past performance is no guarantee of future performance, it is a useful way to assess how well or badly a fund has performed in comparison to its stated objectives and peer group. A good way to do this would be to identify the five best performing funds (within your selected investment objectives) over various periods, say 3 months, 6 months, one year, two years and three years. Shortlist funds that appear in the top 5 in each of these time horizons as they would have thus demonstrated their ability to be not only good but also, consistent performers.

An investor can choose the fund on various criteria according to his investment objective, to name a few:

- Thorough analysis of fund performance of schemes over the last few years managed by the fund house and its consistent return in the volatile market.
- The fund house should be professional, with efficient management and administration.
- The corpus the fund is holding in its scheme over the period of time.
- Proper adequacies of disclosures have to seen and also make a note of any hidden charges carried by them.

The price at which you can enter/exit (i.e. entry load / exit load) the scheme and its impact on overall return.

How To Invest in Mutual Funds ?

Mutual funds normally come out with an advertisement in newspapers publishing the date of launch of the new schemes. **Investors** can also contact the **agents and distributors of mutual funds** who are spread all over the country for necessary information and application forms. Forms can be deposited with mutual funds through the agents and distributors who provide such services. Now a days, the post offices and banks also distribute the units of mutual funds. However, the investors may please note that the mutual funds schemes being marketed by banks and post offices should not be taken as their own schemes and no assurance of returns is given by them. The only role of banks and post offices is to help in distribution of mutual funds schemes to the investors.

Investors should not be carried away by commission/gifts given by agents/distributors for investing in a particular scheme. On the other hand they must consider the track record of the mutual fund and should take objective decisions.

Non-Resident Indians (NRI) can also invest in **mutual funds**. Normally, necessary details in this respect are given in the offer documents of the schemes.

Mutual Fund Offer Document -What to Look For ?

An abridged **offer document**, which contains very useful information, is required to be given to the prospective investor by the mutual fund. The application form for subscription to a **Mutual Fund** is an integral part of the offer document. SEBI has prescribed minimum disclosures in the offer document. An investor, before investing in a **Mutual Fund scheme**, should carefully read the offer document. Due care must be given to portions relating to main features of the Mutual Fund, **risk factors**, **initial issue expenses** and **recurring expenses** to be charged to the Mutual Fund entry or exit loads, sponsor′s track record, educational qualification and work experience of key personnel including **fund managers**, performance of other **Mutual Fund** schemes launched by the mutual fund in the past, pending litigations and penalties imposed, etc.

Can Mutual Fund Change Schemes ?

Yes. They Can However, **no change in the nature or terms of the scheme**, known as **fundamental attributes** of theMutual Fund e.g.structure, investment pattern, etc. can be carried out unless a written communication is sent to each unitholder and an advertisement is given in one English daily having nationwide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated. The **unitholders** have the right to exit the **Mutual Fund** at the prevailing **NAV** without any exit load if they do not want to continue with the scheme. The mutual funds are also required to follow similar procedure while converting the scheme form close-ended to open-ended

scheme and in case of change in sponsor.

The mutual funds are required to inform any material changes to their unitholders. Apart from it, many mutual funds send quarterly newsletters to their investors.

At present, offer documents are required to be revised and updated at least once in two years. In the meantime, new investors are informed about the material changes by way of addendum to the offer document till the time offer document is revised and reprinted.

How to check Mutual Funds Performance

The **performance of a Mutual Fund** is reflected in its **net asset value (NAV)** which is disclosed on daily basis in case of open-ended schemes and on weekly basis in case of **close-ended schemes**. The **NAVs** of **mutual funds** are required to be published in newspapers. The NAVs are also available on the **web sites** of **mutual funds**. All mutual funds are also required to put their NAVs on the web site of **Association of Mutual Funds in India** (AMFI) www.amfiindia.com and thus the investors can access NAVs of all mutual funds at one place

The **mutual funds** are also required to publish their performance in the form of half-yearly results which also include their returns/yields over a period of time i.e. last six months, 1 year, 3 years, 5 years and since inception of schemes. Investors can also look into other details like percentage of expenses of total assets as these have an affect on the yield and other useful information in the same half-yearly format.

The **mutual funds** are also required to send annual report or abridged annual report to the unitholders at the end of the year.

Various studies on **mutual fund** schemes including **yields of different schemes** are being published by the financial newspapers on a weekly basis. Apart from these, many research agencies also publish research reports on performance of mutual funds including the ranking of various schemes in terms of their performance. Investors should study these reports and keep themselves informed about the performance of various schemes of different mutual funds.

Investors can compare the performance of their schemes with those of other mutual funds under the same category. They can also compare the performance of equity oriented schemes with the benchmarks like BSE Sensitive Index, S&P CNX Nifty, etc.

The scheme portfolio shows investment made in each security i.e. equity, debentures, money market instruments, government securities, etc. and their quantity, market value and % to NAV. These portfolio statements also required to disclose illiquid securities in the portfolio, investment made in rated and unrated debt securities, non-performing assets (NPAs), etc.

Some of the mutual funds send newsletters to the unitholders on quarterly basis which also

contain portfolios of the schemes.

Where can an investor look out for information on mutual funds?

Almost all the mutual funds have their own web sites. Investors can also access the NAVs, half-yearly results and portfolios of all mutual funds at the web site of Association of mutual funds in India (AMFI) www.amfiindia.com. AMFI has also published useful literature for the investors.

Investors can log on to the web site of SEBI www.sebi.gov.in and go to "Mutual Funds" section for information on SEBI regulations and guidelines, data on mutual funds, draft offer documents filed by mutual funds, addresses of mutual funds, etc. Also, in the annual reports of SEBI available on the web site, a lot of information on mutual funds is given.

There are a number of other web sites which give a lot of information of various schemes of mutual funds including yields over a period of time. Many newspapers also publish useful information on mutual funds on daily and weekly basis. Investors may approach their agents and distributors to guide them in this regard.