Introduction to

Mutual Fund Investment

What is a Mutual Fund?

Mutual fund is a means for pooling the resources and investing funds in securities in accordance with objectives of the scheme. Investments are made across a wide cross-section of securities and industries, thus reducing the risk through diversification.

Mutual fund issues units to the investors in accordance with quantum of money invested by them.

The profits / losses are shared by the investors in proportion to their investments. The mutual funds come out with a number of schemes with different investment objectives.

What is the role of SEBI in mutual funds industry?

A mutual fund is required to be registered with SEBI. SEBI formulates policies and regulates the mutual funds to protect the interest of the investors.

All mutual funds whether promoted by public sector / private sector / foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirement and all are subject to monitoring and inspections by SEBI.

In addition, the mutual funds have an Association of Mutual Funds in India (AMFI), which also looks into proper functioning of the mutual fund industry.

How is a mutual fund set up?

A mutual fund is set up in the form of a trust, which has sponsor, trustees and an asset management company (AMC).

The trust is established by a sponsor, who is like a promoter of a company. The trustees of the mutual fund hold its' property for the benefit of the unit-holders. AMC manages the funds by making investments in various types of securities. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

What is Net Asset Value (NAV) of a scheme?

The performance of a scheme of a mutual fund is measured by Net Asset Value (NAV).

Mutual funds invest the money collected from the investors in securities. NAV is the total market value of these securities divided by the total number of units of the scheme on any particular date. NAV is required to be disclosed by the mutual funds on a regular basis - daily or weekly - depending on the type of scheme.

What are the different types of mutual fund schemes?

Schemes according to Maturity Period:

Open-ended Scheme

An open-ended scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at NAV. The key feature is the liquidity.

Close-ended Scheme

A close-ended scheme has a fixed maturity period. The fund is open for subscription only at the time of launch of the scheme. The fund is redeemed at NAV on the due date.

To provide an exit route, these funds either list the units on a stock exchange or give an option of selling back the units to the mutual fund through periodic repurchase at NAV.

Schemes according to Investment Objective:

Growth / Equity Oriented Scheme

Growth funds provide capital appreciation over the medium to long-term by investing a major part of their corpus in equities. Such funds are comparatively riskier.

Income / Debt Oriented Scheme

Income funds provide regular and steady income. They invest in fixed income securities such as bonds, debentures, Government securities and money market instruments. They are less risky compared to equity schemes, but the opportunities of capital appreciation are also limited. Their NAVs are affected by changes in interest rates.

Balanced Fund

Balanced funds provide both growth and regular income as they invest both in equities and fixed income securities in the proportion indicated in the offer document.

Money Market or Liquid Fund

These funds are also income funds and provide easy liquidity, preservation of capital and moderate income. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for parking 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 Sensex, Nifty, etc. These schemes invest in the securities in the same weightage as in the index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index.

Sector Specific Funds

These funds invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Petroleum etc. The returns in these funds are dependent on the performance of the respective sectors.

What are Tax benefits in Mutual Funds?

Dividends declared by Mutual Funds are tax-free in the hands of the investor. While there is no Dividend Distribution Tax for Equity schemes, the mutual funds have to pay Dividend Distribution Tax while declaring dividend in income funds.

On selling the units, the investor is liable to pay the necessary Capital Gains Tax. There is, however, no tax on long-term capital gains from equity / balanced funds (equity > 65%).

What is a Load or no-load Fund?

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

What is the sale or repurchase/redemption price?

The price or NAV charged while investing in an open-ended scheme is called sales price. It may include sales load, if applicable. Repurchase or redemption price is the NAV at which the particular scheme purchases or redeems its units from the unit-holders. It may include exit load, if applicable.

Do mutual funds offer assured returns?

Most funds in the market today do not offer any assured return. 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.

Can non-resident Indians (NRIs) invest in mutual funds?

Yes, non-resident Indians can also invest in mutual funds.

How much should one invest in debt or equity oriented schemes?

An investor should take into account his risk taking capacity, age, financial position, etc. As already mentioned, the schemes invest in different type of securities and offer different returns and risks. Investors should consult financial advisors in this regard.

What should an investor look into an offer document?

An investor should carefully read the offer document especially the main features of the scheme, risk factors, initial issue & and recurring expenses, entry / exit loads, sponsor's track record, key personnel including fund managers, performance of other schemes launched by the mutual fund in the past, pending litigations and penalties imposed, etc.

How much time will it take to receive dividends/repurchase proceeds?

A mutual fund usually dispatches the dividend warrants within 30 days of the declaration of the dividend and the redemption proceeds within 1-3 working days from the date of redemption/repurchase request made by the unit-holder.

How to know the performance of a mutual fund scheme?

The performance of a scheme is reflected in its net asset value (NAV).

Investors can compare the performance of their schemes with other mutual funds under the same category and also with the respective benchmarks.

Mutual funds also disclose full portfolios of all of their schemes on regular basis. The scheme portfolio shows investment made in each security i.e. equity, debentures, money market instruments, government securities, their quantity, market value and % to NAV.

Are schemes with lower NAV better than those with higher NAV?

Some investors prefer a scheme with lower NAV or a new scheme as compared to the one available at higher NAV. It may be noted that for mutual fund schemes, lower or higher NAVs of similar type schemes of different mutual funds have no relevance.

Say scheme A has NAV of Rs.15 and scheme B Rs.90. Investor has put Rs. 9,000 in each of the two schemes. He would get 600 units (9000/15) in scheme A and 100 units (9000/90) in scheme B. Assuming that the markets go up by 10%, NAV of scheme A would go up to Rs. 16.50 and of scheme B to Rs. 99. Thus, the market value of investments would be Rs. 9,900 (600* 16.50) in scheme A and also Rs. 9900 in scheme B (100*99). Thus the investor gets the same return in each of the schemes.

Similarly, dividends from a mutual fund are not something extra. They are already reflected in the NAV growth and hence on dividend declaration the NAV falls equal to the dividend declared.

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