Concept and Role of a Mutual Fund

Basic Concepts of Mutual Fund

Mutual Fund is a **collective investment vehicle**

- Mutual Fund is an **indirect** way of investing in capital markets
- Mutual Fund is a pool of money collected from a **large no. of investors** (**min. 20)**
- Each such pool of money is called a **mutual fund scheme**
- Pool of money so collected is invested in a **diversified portfolio** of **marketable** securities by professional fund managers in accordance with stated objective.
- Every scheme has a pre-announced investment objective.
- Ownership of fund is **mutual, beneficial & proportionate** to contributions made by each investor.

Basic Concepts of Mutual Fund

- Primary role is to assist investor in earning an income or building their wealth by participating in opportunities available in various security market
- When a scheme is first made available to investors for investment, it is called a **'New Fund Offer'(NFO)**
- During the NFO, investors have option to buy units at their **face value** (normally, Rs. 10/-)
- After the NFO, when the investors buy into a Scheme, they need to pay a price that is linked to its **NAV**
- **Unit Capital =** No. of Units*Face Value. It is also called the **corpus** of the fund. It changes depending on the nature of the fund.

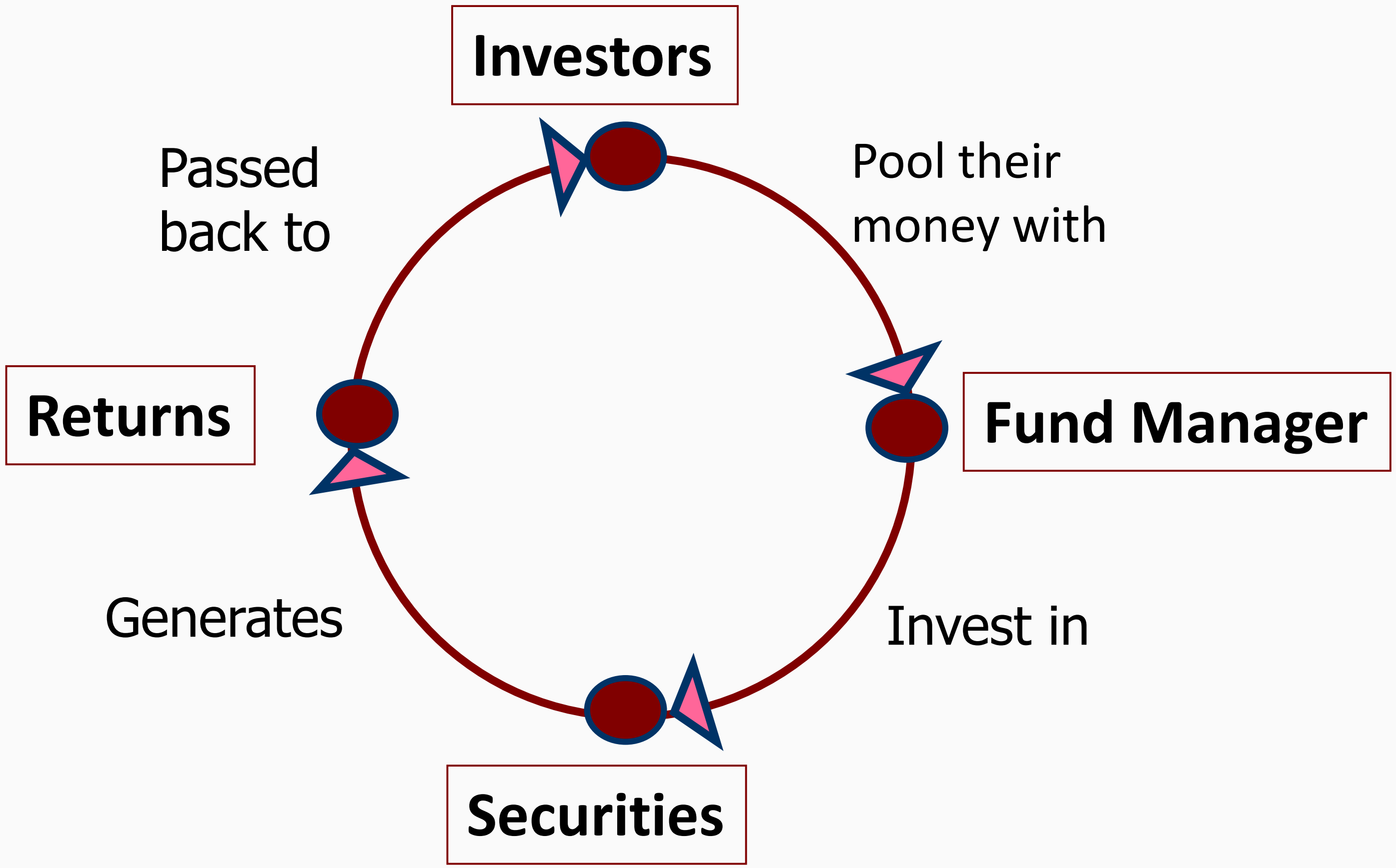
Basic Concepts of Mutual Fund

- **Portfolio** is a collection of securities
- It is possible for mutual funds to structure a scheme for any kind of investment objective
- Mutual funds can invest only in **marketable securities**
- Value of the investment portfolio changes with a change in market price of the securities
- **'Marking to market'** – It is a process of using market price to value an investment portfolio
- **Unrealised gains or Unrealised losses** – Gains or losses in value of the sec., but not realised through a sale
- **Total Assets =** Market value of all the securities held in the portfolio

Basic Concepts of Mutual Fund

- **Assets Under Management (AUM)** = Total Assets + Current Assets
- Mutual Fund does not hold any long term assets or liabilities
- **Net Assets** = Total assets + Accrued income – Current liabilities – Accrued expenses
- **Net Asset Value** = Net assets / Units outstanding = Value per unit at current market prices
- The net assets of a mutual fund may go up/down due to the following reasons:
  Entry /exit of investors, Income from dividends or interest/ Expenses, Realised gains/losses, Unrealised gains/losses

MUTUAL FUND OPERATION FLOW CHART



Advantages and Limitations of Mutual Funds

Advantages	Disadvantages / Limitations
1. Professional Fund Management	1. Lack of portfolio customization
2. Portfolio Diversification	2. Choice Overload (Over 800 Mutual Fund Schemes offered by 38 Mutual Funds)
3. Economies of Scale	3. No control over costs
4. Easy Liquidity	
5. Tax Deferral / Tax Benefits	
6. Convenient Options	
7. Investment Comfort	
8. Regulatory Comfort	
9. Systematic approach to investments	

Mutual Fund Schemes (Structure-wise)

Open –Ended Funds

- No fixed maturity date
- Units open for sale & purchase **from Mutual Fund** at all times
- No. of units & unit capital keep on changing daily
- Transactions are NAV-based

Close –Ended Funds

- Fixed maturity date
- Offered in an NFO but are closed for further purchases after NFO
- Compulsorily listed on a stock exchange to provide liquidity
- Unit capital remains constant

Mutual Fund Schemes (Structure-wise)

Interval Funds

- Combine features of both open-ended and close–ended schemes
- Largely close–ended but become open-ended at pre–specified intervals

Types of Funds - By Investment Objective

- **Equity** : E.g. Diversifed equity fund, Index fund, Sector fund, Arbitrage fund, ELSS, Dividend yield schemes.
- **Debt**: E.g. GILT fund, FMP, Junk bond fund, Liquid schemes
- **Hybrid**: E.g. MIP, Capital Protection Fund

Actively Managed Funds and Passive Funds

- **Actively managed funds**
  - Fund manager can construct investment portfolio within broad investment objectives of the Schemes
- **Passive Funds**
  - Fund manager can invest on the basis of a specified index eg. BSE Sensex or Nifty 50
  - These Schemes are also called **Index Schemes** where fund manager has no role in deciding on investments
  - These Schemes have low running costs

Types of Equity Funds - A Risky asset class

- Aggressive Growth Funds (targets maximum capital appreciation.)
- Growth Funds (capital appreciation over 3 to 5 years at above average rate.)
- Speciality Funds
- Sector Funds (Bank, Power, Pharma, IT, Telecom)
- Foreign Securities Fund
- Mid cap or Small cap Equity funds
- Diversified Equity Funds (do not focus on any one or few sectors or shares)
- Equity Index Funds (these funds take only the overall market risk)
- Value Funds (invests in the companies whose shares are underpriced)
- Equity Income or Dividend yield funds

Types of Equity Funds

Equity Funds

- **Index Funds**
  - BSE Sensex 30 Index
  - NSE Nifty Index
- **Diversified Equity Funds**
  - ELSS Funds
  - Dividend Yield Funds
  - Growth Funds
  - Value Funds
- **Specialty Funds**
  - Sector Funds
  - Thematic Funds

Arbitrage Funds

Note: Index Funds replicate a chosen underlying index. Exposed to **tracking error ELSS Funds** section 80 C benefit with **3 yr lock-in period**

Types of Equity Funds

- **Growth Funds**
  - Invest in companies whose earnings are expected to grow at an above average rate
- **Value Funds**
  - Identify stocks of good quality companies whose real worth has not yet been realised
- **Mid-cap and Small-cap Funds**
  - Focus on smaller and emerging companies for their higher growth potential

Types of Equity Funds

- **Dividend Yield Funds/Equity Income Funds**
  - Invest in companies that have a high dividend yield
  - Attractive in bear and over-valued markets due to less volatility and regular dividend income
- **Arbitrage Funds**
  - Take equal and opposite exposure in different markets
  - Earn a return due to difference in price in the two markets

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ELSS (Equity Linked Saving Scheme)

- 3 year lock in period
- Minimum investment of 90% in equity markets at all times
- So ELSS investment automatically leads to investment in equity shares
- Eligible under Section 80 C up to Rs.1 lakh allowed
- Dividends are tax free
- Benefit of long term capital gain taxation

Types of Debt Funds

1	Gilt Funds	i. Long term gilt funds ii. Short term gilt funds	i. Invest in Govt. Securities & Treasury Bills only
2	Bond Funds	i. Diversified Debt Funds ii. Fixed Maturity Plans (FMP)	i. Invest in Govt. Securities & Corporate Bonds ii. Invest in Securities of matching maturity
3	Junk Bond Schemes	i. High Yield Bond Schemes	i. Invest in High return bonds
4	Floating Rate Funds	i. Interest rate changes with the market rate	i. Invest in floating rate bonds

Money Market Funds

- Money Market Funds are also called as **Liquid Funds.**
- **Liquid Funds** are **a kind of Debt Fund**
- Liquid Funds invest only in debt securities where the monies will be repaid **within 91 days**
- They offer high liquidity & safety of principal
- They are low risk and low return funds

Types of Hybrid Funds

- A Fund investing in a mix of debt, equity and money market instruments within pre-specified proportions is called a **Balanced Fund** or a **Hybrid Fund**.

- If the Fund Manager is allowed to change the proportion of investment into debt, equity and money market depending upon market perception, it is called **Asset Allocation Fund** with flexible asset allocation.

Types of Hybrid Funds

- **Hybrid Funds**
  - **Balanced Funds**
    - Equity Oriented Balanced Funds
    - Debt Oriented Balanced Funds
      - Monthly Income Plans
      - Capital Protected Schemes
  - **Asset Allocation Funds**
    - Flexible Asset Allocation

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Other Fund Categories

• Exchange Traded Funds	:	Trade like a stock on stock exchange
• Gold Sector Funds	:	Invest in shares of gold mining Cos.
• Commodity Funds	:	Invest in Stocks of Commodity Cos.
• Real Estate Funds	:	Invest in Stocks of Real Estate Cos
• Fund of Funds	:	Invest 100% in other Mutual Fund Schemes and not in securities
• International Funds	:	Invest out side the country
	:	'Feeder' Fund ties up with the 'Host' Fund in an FoF structure

Real Estate Funds

- **Real Estate Funds**
  - May invest directly in Real Estate, or
  - May fund Real Estate developers through Bonds
  - Buy shares of Housing Finance companies or
  - Buy securitized assets of Housing Finance companies

Exchange Traded Funds

- An open ended Index funds that are traded on stock exchange.
- A feature of open ended funds which allows investor to buy & sell units of MF scheme. Such feature is allowed only to very large number of investors in an ETF. ETF is exempted from Wealth Tax.
- Investors have to buy & sell ETF only on Exchange platform.
- A baskets of securities that are traded, like individual stocks, on an exchange.
- ETF`s can be bought and sold throughout the trading day like any stock. Like gold ETF might be traded higher or lower than its NAV.
- One must pay a brokerage to stock broker to buy & sell ETF units.
- ETF is eligible for LTCG after 1 year as compare 3 yrs. in physical gold.
- World over ETF trading is widely accepted among investors.

International Fund

- These are the funds that invests outside the country. For Ex. MF may offer scheme to investor in India with an investment objective to invest abroad.

- One way for the fund to manage the investment is to hire the requisite experts for the same .

- Alternative route would be to tie up with a foreign fund (Host Fund).
  For Ex. if an MF sees potential in Brazil it will tie up with Brazilian fund.

International Fund

- Investors in India will invest in feeder fund. The money collected in such fund would invest in the host fund and return on such fund will be given to investors .

- Thus when Brazilian market does well host fund do well & Feeder Fund in India will also do well.

- This is one of the better idea for diversification of investment.

Question for Revision

Q-1 : Mutual fund is exempted from Wealth Tax

(a) True

(b) False

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Question for Revision

Q-2 : Mutual fund are constituted in India as…

(a) Companies

(b) Trust

(c) Partnership Firm

(d) NGO.

Question for Revision

Q-3: Gold funds can invest in

(a) Gold

(b)Gold futures

(c) Shares of gold mines

(d) All of the above.

Question for Revision

Q-4: Which of the following fund would fall under passive management?

(a) Diversified Equity Fund

(b) Index Fund

(c) Equity Growth Fund

(d) All of Above

Question for Revision

Q-5: Which one of the following funds does not qualify as a speciality fund?

(a) Pharma Fund

(b) Balanced Fund

(c) Small-Cap Fund

(d) Emerging Markets Fund

Question for Revision

Q-6: After NFO in Open Ended fund transactions can be done by?

(a) Existing Investors

(b) Existing & New Investors

(c) New Investors

(d) None of the Above

Question for Revision

Q-7: Compare to Sector Funds Thematic Fund would have a wider choice for investment ?

(a) True

(b) False

Question for Revision

Q-8: Close ended fund allows investors to sale their units

(a) By allowing fixed number of Units to sale

(b) By selling number of units in a fixed interval

(c) By listing MF in stock exchange

(d) Cannot sale

Question for Revision

Q-9 : One of the advantage of ETF is..

(a) Investor can see where his money is invested

(b) These schemes can generate higher returns than mutual fund.

(c) Investors can buy of sell units on stock exchanges at price that closely track valuation at that time

(d) ETF offer tax benefits.

Question for Revision

Q-10: Whats is true about the FMP

(a) NAV does fluctuate

(b) No default Involved

(c) Returns can be reasonably predicted before the maturity

(d) All of the above

Question for Revision

Q-11: During New Fund Offer (NFO) units of Open Ended fund are purchased from

(1) A Broker

(2) The Mutual Fund itself

(3) A depository

(4) Stock exchange

Question for Revision

Q-12: A closed ended mutual fund has fixed

(1) Market value of assets under management

(2) Net asset value per unit

(3) Unit capital and number of units

(4) Assets and Liability.

Answers for Revision

A-1 : (True)

A-2 : (b)

A-3 : (d)

A-4 : (b)

A-5 : (b)

A-6 : (b)

A-7 : (True)

A-8 : (c)

A-9 : (c)

A-10: (c)

A-11: (b)

A-12: (c)