Module 3-MUTUAL FUND

1. What is Mutual fund?

A mutual fund is an investment vehicle where many investors pool their money to earn returns on their capital over a period. This corpus of funds is managed by an investment professional known as a fund manager or portfolio manager. The gains or losses on the investment are shared collectively by the investors in proportion to their contribution to the fund.

2. Expand: AMFI, ETF,FOF,NAV

AMFI=Association of Mutual Funds in India
ETF= Exchange Traded Funds
FOF=Fund of funds
NAV=Net Asset Value
SEBI=Securities and Exchange Board of India

3. State any two advantages/ disadvantages of Mutual funds.

Advantages

- Variety of investment structure
- Affordable and accessible
- Ability to make regular and systematic investments
- Wealth creation
- Liquidity
- Well regulated and controlled
- Expertise of Fund manager
- Tax benefits and deferrals

Disadvantages

A. Lack of portfolio control and choice
B. Choice overload
C. Lack of cost control

4. Mention the various schemes of Mutual fund.

- Organization Structure:-open ended, close ended, interval
- Portfolio Management strategy-Active or Passive
- Investment objective-Growth, Income, Liquidity
- Underlying Portfolio-Equity, Debt, Hybrid, Money market instruments, multi Asset
  Sector specific funds
- Thematic/solution oriented-Tax saving, Retirement benefit, child welfare, Arbitrage
- Exchange Traded Funds
- Fund of Funds

5. Explain the types of Mutual schemes.

A)<u>By Organisation Structure</u>

a. **<u>Open ended schemes:-</u>** These are perpetual, and open for subscription and repurchase on a continuous basis on all business days at the current NAV.

b. **<u>Close ended schemes</u>:-**The units are issued at the time of the initial offer and redeemed only on maturity.

c. **<u>Interval schemes</u>**:- These allow purchase and redemption during specified transaction periods (intervals). The transaction intervals has to be for minimum 2 days and there should be at least a 15 days gap between 2 intervals.

<u>B)By Portfolio Management Strategy</u>

Active Funds: the fund manager is "active" in deciding whether to Buy, Hold or Sell securities

Passive Funds: the fund manager has a passive role in deciding to buy, hold or sell, decisions Driven by Benchmark Index.

<u>C) By investment objective</u>

<u>Growth Fund (equity)</u>: Growth funds are typically designed to provide capital appreciation

<u>Income Fund(debt):</u> The objective of Income fund is to provide regular and steady income to investors

<u>Liquidity</u>: Liquid Schemes, overnight funds and money market mutual funds are for liquidity and principal protection with minimum returns(commercial papers, treasury bills)

<u>D) By Underlying Portfolio</u>

Equity scheme primarily invest in equity instruments Debt scheme invests in fixed income securities

Money Market/liquid schemes are those that invest in short term money market instruments.

Multi Asset scheme/Hybrid schemes invest in more than one asset class and combined equity, debt and money market instruments

<u>E) By Sector</u>

Funds invest in a particular sector of the economy such as infrastructure, banking, technology, pharmaceuticals, or FMCG. They limit diversification thus riskier.

<u>By Themes/solution oriented</u>

Funds are oriented towards specific solution :- Tax saving(ELSS),Retirement Benefits, Child welfare

6. **What is Exchange Traded funds(ETF)**

An ETF is a marketable security that track index, a commodity, bonds or basket of assets. ETF are listed on stock exchanges.

Unlike regular MF, an ETF trades like a common stock on a stock exchange. ETF Units are compulsorily held in Demat mode

ETFs are passively managed

7. **What Fund of Funds**

FOF are mutual funds schemes invest in other mutual funds.

8. **What do you mean by Net Asset Value? How it calculated (Formula)?**

Ans. Net Asset value refers to the value of each unit of the scheme NAV=(Total Assets - Liabilities/expenses) / No. Of units outstanding

9. **Mention any two key participants of Mutual fund Industry.**

Sponsor:-A sponsor is a person or an entity that setup a mutual fund

Trustee:- The trustees of a mutual fund hold the property of the fund for the benefit of the unit holder, they monitor its performance and compliance with SEBI Regulations

Asset Management Company:- AMC manages the funds by making investments in various types of securities. This must be approved by SEBI.

Custodian:-The custodian holds the securities of various schemes of the fund in its custody. The custodian must be registered with SEBI

Subscribers:-The investors are called subscribers.

Registrar and transfer Agents:- acts as mediator or agent between investors and mutual fund houses

10. **Who is Fund Manager:-**

A fund manager is a person who oversees the activities of a mutual fund. He is responsible for implementing a funds investment strategy and managing its trading activities.

11. **Who is Fund Accountant**:- A fund accountant is responsible for the day to day aspects of accounting of mutual fund. They also prepare NAV, yields, distributions and other fund accounting outputs for subsequent reviews.

12. Mention the six levels of Risk–o-meter.

a) Low risk
b) Low to moderate risk
c) Moderate risk
d) Moderately high risk
e) High risk
f) Very high risk

13. What is Sharpe Ratio? How it is calculated (Formula)?

Sharpe ratio is a very commonly used measure of risk adjusted returns.

An investor can invest with the government and earn a risk free rate of return (R_f).

T-Bill index is a good measure of this risk free return.

Through investment in a scheme, a risk is taken and a return is earned(R_s).

The difference between the two returns i.e. R_s - R_f is called risk premium. It is like premium that the investor has earned for the risk taken , as compared to governments risk free return.

This risk premium is to be compared with the risk taken. Sharpe Ratio uses Standard Deviation as a measure of risk.

Sharpe Ratio=(R_s-R_f)/Standard Deviation

14. What is Treynor Ratio? How it is calculated(Formula)?

Treynor Ratio is a risk premium per unit of risk.
For Risk, Treynor Ratio uses Beta.
Treynor Ratio=(R_s-R_f)/Beta

14. What do you mean by Alpha? What does a positive Alpha/Negative alpha indicate?

Non index schemes too would have a level of return, which is in line with its higher or lower beta as compared to the market. Let us call this the optimal return.
The difference between a schemes actual return and its optimal return is its Alpha -a measure of the fund managers performance. Alpha, therefore, measures the performance of the investment in comparison to a suitable market index.
Positive alpha is indicative of out performance by a fund manager; negative alpha might indicate under performance.

15. **What do you mean by Beta?**

Beta is based on the Capital Asset Pricing Model(CAPM),which states that there are two kinds of risk in investing in equities- Systematic risk and non systematic risk.

Systematic risk is integral to investing in the market; it cannot be avoided.

Non systematic risk can be diversified away, investors need to be compensated only for systematic risk, according to CAPM. This systematic risk is measured by its Beta Beta measures the fluctuation in periodic returns in a scheme, as compared to fluctuation in periodic returns of a diversified stock index (representing the market) over the same period.

The diversified stock index, by definition, has a Beta of 1.Companies or schemes, whose beta is more than 1, are seen as more risky than the market and vice versa.

16. **What are the steps involved in Financial Planning?.**

i. Establish and define the client planner relationship

ii. Gather client data, including goals

iii. Analyze and evaluate financial status

iv. Develop and present financial planning recommendations

v. Implement the financial planning recommendations

VI Monitor the financial planning recommendations

17. Mr. Ravi earns monthly Rs.20,000& his wife earns Rs.18,000. He owns twohouses.He& his family stays in one house & the other house has rented for Rs. 8000/ month. He has a home loan & its Monthly EMI Costs Rs.10000. His other monthly expenses are : School fees of his only child (Installment) Rs. 5000 , Insurance premium : Rs. 500 , Food & groceries : Rs. 6000 , Transportation : Rs. 3000, Mobile & Internet recharge Rs. 1000/-, Water Bill Rs. 100/- , other miscellaneous expenses : Rs. 5000/ - .Can you help Mr. Ravi to calculate his Net savings ?

18. Imagine you have an Income of Rs. 25,000/- . Your monthly family & other personal commitments costs to Rs. 15,000/- . Can you draft a imaginary allocation of your savings keeping in mind the concept of liquidity , safety & profitability

19. From the following Compute NAV of a Mutual Fund Unit Total Assets of the Fund – Rs. 54,50,000, Liabilities – Rs. 4,85,000 & Total units - 325000.

20. Calculate the NAV per unit from the following information: Mutual fund scheme = Rs. 20,00,000

Face value of Units=Rs.10

Number of outstanding units=2,00,000

Market value of fund's investment=Rs.28,00,000

Bills Receivable = Rs. 40,000

Liabilities=Rs.20,000

21.Explain steps involved in financial planning

STEPS INVOLVED IN FINANCIAL PLANNING

Financial planning can be undertaken by each of us for our activities. However, it is prudent to take up the services of financial advisors as they bring in the much-needed expertise in terms of various solutions.

This section of the chapter, we would focus on the process/steps undertaken by financial advisors for their clients' financial planning.

Financial planning requires financial advisors to follow a process that enables acquiring client data and working with the client to arrive at appropriate financial decisions and plans, within the context of the defined relationship between the planner and the client.

The following is the **six-step process** that is used in the practice of financial planning:

1. **Establish and define the client-planner relationship:** The planning process begins when the client engages a financial planner and describes the scope of work to be done and the terms on which it would be done.
2. **Gather client data, including goals:** The future needs of a client require clear definition in terms of how much money will be needed and when. This is the process of defining a financial goal.
3. **Analyse and evaluate financial status:** The current financial position of a client needs to be understood to make an assessment of income, expenses, assets and liabilities. The ability to save for a goal and choose appropriate investment vehicles depends on the current financial status.
4. **Develop and present financial planning recommendations:** The planner makes an assessment of what is already there, and what is needed in the future and recommends a plan of action. This may include augmenting income, controlling expenses, reallocating assets, managing liabilities and following a saving and investment plan for the future.
5. **Implement the financial planning recommendations:** This involves executing the plan and completing the necessary procedure and paperwork for implementing the decisions taken with the client.
6. **Monitor the financial planning recommendations:** The financial situation of a client can change over time and the performance of the chosen investments may require review. A planner monitors the plan to ensure it remains aligned to the goals and is working as planned and makes revisions as may be required.

Ten stages of financial life

The Ten Financial Stages of Life

Experts have divided life into ten typical financial stages. There are specific wealth building strategies for each stage and financial ratios that mark the transition from one stage to the next. The most unreliable indicator on the Financial Life Cycle is the age range. People can spend 50 years stuck in a stage or skip it altogether. A divorce can move people backward and commitment to a Wealth Plan can jump them forward. So don't be discouraged if you're "behind" and don't get too excited if you're "ahead".

Life Stages #1 & 2: Toddler & Childhood

The first two stages are Toddler (Early Childhood) and Childhood. During the Toddler stage (0-5) we believe that money is to eat. Our parents teach us that eating money is not a sound financial strategy (or healthy habit). By Childhood, which we define as age 6 to 12, our parents have taught us ***three more financial concepts: accumulation, convertibility and relative value***. In the old days parents taught us to accumulate when they gave us an allowance and a piggy bank in which we had to save some of the allowance. We learned about convertibility when our parents let us spend some of our allowance to buy things. Relative value means we learned that dimes are worth more than nickels even though dimes are smaller.

Life Stage #3: Teenage Years

During the Teenage years, from about 12 to 19, we learn ***two more concepts: budgeting and earned income and how money makes money***. We learn about budgeting when our parents give us a clothing allowance and make us buy our own clothes. We learn about earned income when we make and sell stuff (like cakes/cookies/paper craft gifts) for a profit or when we take tuitions for money. During this stage, some children get side-tracked with the idea of moving out on their own, but that seems to be occurring less frequently.

Life Stage #4: Building the Foundation

During our 20s, we enter the Building the Foundation stage. During these years we become completely self-supporting. These are the **critical years** where we establish the financial habits that will determine our financial future.

There are three basic ways to acquire money:

1. The first is by **affiliation** - you marry it, inherit it, or are given it. It's common to think that this is the easy way to wealth, but in our experience it seldom is. Money obtained this way seldom lasts because the recipient hasn't learned the basic concept of how to invest money. Thus "a fool and his money are soon parted".
2. The second way to get money is to **earn it by the sweat of your brow**. While this is honourable, most people yearn to get to a point in their life where they can do what they want to do (self-actualization) without having to worry about how much money they make.
3. The third way to acquire money is to have **your money make money for you**. This means saving and investing until you have accumulated a pile of money big enough to earn more than you earn by the sweat of your brow. When your money makes enough money to cover your living expenses then you have achieved financial freedom. Understanding this goal of financial independence is crucial for clients to get beyond the Building the Foundation stage.

Life Stage #5: Early Accumulation

At the point, usually between 30 and 40, that our net worth exceeds our annual income, we move into the Early Accumulation stage. This is where basic investment begins and we teach clients how to diversify.

Life Stage #6: Rapid Accumulation

... our net worth is three (3x) times our annual income; we reach the point

Life Stage #7: Financial Independence

At this point our key financial ratios change. Instead of measuring Net Worth/Income we calculate Investment Portfolio/ Living Expenses. When our investable assets have grown to between seven and ten times (7-10x) our annual living expenses we pass into the stage of Financial Independence.

This usually occurs between ages 55 and 70. At this stage we have options - to change jobs, semi-retire or have a mid-life crisis. At this point we can use some of the income from our investments to subsidize our living expenses so that we don't have to work full-time at a job we don't really like. At this point our strategic priorities also change from accumulating wealth to conserving wealth. Not falling backwards becomes more important than moving forward.

Life Stage #8: Conservation

When our investable assets are ten to fifteen times (10-15x) our living expenses, the earnings and any income from pensions are usually adequate so that we don't have to work anymore. While many call this retirement, we call it the Conservation stage. We have arrived at our destination, so why should we risk going backwards just to accumulate a little more? Many clients find it difficult to invest conservatively after years of pursuing a "growth" portfolio. It seems "wasteful" to not try to get a higher investment return.

Life Stage #9: Distribution

If we continue to practice the fundamentals of fiscal fitness, we eventually reach the point where our net worth exceeds 15 times (>15x) our annual expenses. At this juncture we have more money than we can spend in our lifetime. We enter the Distribution stage. At this point we "invest in memories" and ensure our financial legacy. We gift money to children or fund a family cruise. We may gift money to charities, set up endowments and create an estate plan that will shape the values on our descendants.

Life Stage #10: Sunset

The Sunset stage comes when we have less than 12 months to live, and we try to provide for the orderly distribution of the bulk of our assets.

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