A to Z of MUTUAL FUNDS – An Ideal Investment Option for Investors

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The article presents an insight of the mutual fund industry in India, its development since inception with UTI, entry of public sector banks and insurance companies to private and foreign enterprise, the varieties and types offered by fund companies especially tailored to meet small investor's needs. It also elaborates their relative merits along with some practical guidelines to choose from a wide variety that would result in safe investment and reasonable return.

The twenty-first century unfolds unprecedented growth for the Indian economy along with employment generation, increase in disposable income and scope for higher savings. It set a virtuous cycle with more money in the market and financial institutions offering a wide range of investment schemes designed to meet the individual's specific need. Alongside, spread of education and information too has created awareness not only of the avenues for savings and earnings, but also the necessity for a secure future amidst uncertainty.

It cannot be denied that with the sensex climbing up with every day, the market has expanded exponentially; from a limited option like fixed deposits, units in Unit Trust of India (UTI) to a host of plans to choose from including on-line trading facilities by anyone. Though term deposits in banks and post office remains a risk free proposition, the return on such investment is relatively low, especially with modest interest rate. The other avenues, with a degree of risk in investment are many: stocks, debentures, mutual funds, derivatives like forwards, futures, options, swaps and so on. Among these, mutual funds have gained investors' acceptance and confidence.

What is Mutual Fund?

A mutual fund is a professionally managed collective investment scheme that pools money from many investors and invests the funds typically in investment securities (stocks, bonds, short-term money market instruments, other mutual funds, other securities, and/or commodities such as precious metals). It is used as a generic term for various types of collective investment vehicles, such as regular income plan, open-ended investment with dividend or growth option, index funds, tax saving schemes etcetera.

Its Development so far

The origin of mutual fund is traced to Massachusetts Investors Trust (now MFS Investment Management) of America, founded on March 21, 1924 initially offering a few closed-end funds. By the end of the 1960s, there were approximately 270 funds in USA with $48 billion in assets. The first retail index fund, First Index Investment Trust, was formed in 1976 is now called the Vanguard 500 Index Fund and is one of the world's largest mutual funds, with more than $100 billion in assets.

As per available estimates, by 2008, the worldwide value of all mutual funds totalled more than $26 trillion of which over eight thousand mutual funds belong to the United States, with combined assets of $12.36 trillion and in India it stands at Rs. 7,475 billion($ 170 billion)in March 2010.

India's development

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and its development could be broadly divided into four distinct phases:

- Phase I (1963-87): Unit Trust of India was established on 1963 by an Act of Parliament to function under the Reserve Bank of India (RBI). The first scheme launched by UTI was Unit-1964 and the flagship scheme gained popularity across all income levels with millions of small investors. In 1978, UTI was de-linked from the RBI and the Industrial Development Bank of

India (IDBI) took over the administrative control. At the end of 1988 UTI had Rs.6,700 crore of assets under its management.

- Phase II (1987-1993): 1987 marked the entry of non- UTI, public sector mutual funds set up by public sector banks, Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was set up in June 1987 followed by Canbank Mutual Fund (Dec 87), LIC (June 1989), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), GIC (December 90), Bank of Baroda Mutual Fund (Oct 92). By the end of 1993, the mutual fund industry had assets of Rs. 47,004 crore under management.
- Phase III (1993-2003) (Entry of Private Sector Funds): Post liberalization, Government permitted the entry of private sector funds in 1993 and a new era started in the Indian mutual fund industry. And all mutual funds, except UTI was administered under the Mutual Fund Regulations asking all funds to be registered. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

  The industry now functions under a more comprehensive and revised Mutual Fund Regulations, 1996 under Securities and Exchange Board of India (SEBI).
- Phase IV (since February 2003): In January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crore of which the assets of Unit Trust of India to the tune of Rs. 44,541 crore and in February 2003 the Unit Trust of India Act, 1963 was repealed and the UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets of Rs. 29,835 crore under its management representing broadly, the assets of US-64 scheme and certain other schemes functioning under an administrator and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund, sponsored by State Bank of India, Punjab National Bank, Bank of Baroda and LIC is registered with SEBI and functions under the Mutual Fund Regulations.

The number of companies offering mutual fund are increasing with many foreign mutual funds setting up funds in India including several mergers and acquisitions.

At present there are 40 companies offering mutual funds in India and Reliance (15 percent), HDFC (12 percent), ICICI and UTI (11 percent each) emerged as major players. The mutual fund industry seems to have entered its current phase of consolidation and growth.

Investment Objective

In India, a fund is registered with the SEBI who oversees fund's compliance to the set rules and guidelines including distribution of its net income and net realized gains from the sale of securities (if any) to its investors. Most funds also have a board of directors whose job is to decide the company's policy, objective and ensure that the fund is managed properly in the best interests of the fund's investors. The mutual fund will have a fund manager responsible to trade (buy and sell) the fund's investments in accordance with the fund's investment objective. And a mutual fund is also advised by the investment adviser who works under an advisory contract.

Keeping in view the investment objective, the mutual fund schemes are set forth in the fund's prospectus, which is the legal document of the fund offered for sale. It contains comprehensive information about the fund including proposed investment in kinds of securities.

Different types of Mutual Fund

An important way of differentiating mutual funds by an investor is according to their structure, principal investment objective and key features like return and redemption. This enables the investors to spread their money in a mix of funds according to their financial position, risk tolerance and return expectations. The mutual fund companies accordingly have designed a range of investment products. These could broadly be classified based on asset class, investing strategy and style, availability of return etc. and without much technicalities, the salient features of major mutual fund schemes are explained.

Tenure Based

Open-ended and close-ended funds

The mutual fund unless specified is an open-end fund and being open-ended means that the fund continually issues new shares to investors buying into the fund and stands ready to buy back shares from investors redeeming their shares every day. An investor will generally purchase shares in the fund directly from the fund itself rather than from the existing shareholders.

Closed-end funds, also called fixed maturity fund, in contrast are offered to the public at a single time under new fund offer (NFO) to mature after a definite time frame. The fund's shares are subsequently traded with buyers and sellers in the secondary market at a market-determined price. Except for some special transactions, the fund cannot grow in size by attracting more investor capital like an open-end fund. And at the end of the period, the investor has option either to redeem or switch to other scheme of the mutual fund.

Payout Related

Monthly Income Plan (MIP)

The potential investors in India comprise the salaried class, entrepreneurs and businessmen. The employed live on a monthly income and after retirement, the regular income ceases for majority. They prefer regular income to continue with family expenditure and a secure life. This group would prefer payouts from the mutual fund at regular intervals. MIP thus has become most popular for investors and as per the statistics; it constitutes 51 percent of the total mutual fund investment. The fund managers, in order to offer an assured return invest most of the money (over 80 percent) in debt and the balance in equity. The name is a misnomer as the payout may be monthly, quarterly or the investor may choose growth option.

Dividend, Dividend-reinvestment or Growth Options

A group, though few has surplus for investment during job tenure, active business and also after without any immediate demand for money. They invest on long-term and prefer dividend, dividend-reinvestment where the dividend accrued is reinvested or growth option. The dividend reinvestment or growth option has tax advantages: dividend is tax free and investment over a 12 month period is exempt of long term capital gain tax on equity mutual funds.

Classification Based on Financial Instrument

Debt Fund

A debt fund is a type of mutual fund in which core holdings are fixed income investments such as short-term or long-term bonds, securitized products, money market instruments or floating rate debt. The main investing objectives of a debt fund being preservation of capital and generation of income, performance against a benchmark is considered to be secondary to absolute return. The debt fund is either liquid money market or short-term and long-term. The liquid money market fund is third most popular in India with 13 percent of assets.

The fee ratios on debt funds are lower, on average, than equity funds because the overall management costs are lower.

Equity fund

A mutual fund that invests principally in stocks is termed as Equity fund. It is the most common type of mutual fund, holding at least 50 percent of all amounts invested in equity focus investments on particular strategies and certain types of issuers. As the fund invests primarily in stocks, it is usually subject to the same ups and downs and risks as the stock market. Equity funds actively managed and second most popular with 28 percent assets.

The objective of an equity fund is long-term growth through capital gains, although historically dividends have also been an important source of total return. Specific equity funds may focus on a certain sector of the market or may be geared toward a certain level of risk.

Equity funds are principally categorized according to company size, the investment style of the holdings in the portfolio. Funds may focus on some size of company and traditionally, companies are divided into large-cap, mid-cap, and small-cap and size is determined by a company's market capitalisation.

Mid-cap funds are those mutual funds, which invest in small/medium sized companies. These funds are a good option in case the investor wants to add some diversity to his portfolio though these are very volatile and tend to fall like a pack of cards in bad times. So, caution should be exercised while investing in mid cap mutual funds.

One of the biggest advantages of investing in small-cap stocks is the opportunity to beat institutional investors. Because mutual funds have restrictions that limit them from buying large portions of any one issuer's outstanding shares, some mutual funds would not be able to give the small cap a meaningful position in the fund.

Balanced funds

Balanced mutual funds also called asset allocation funds make it possible by investing in an assortment of investment instruments such as stocks, money markets and bonds. The proportion in which the balanced mutual funds allocate their assets is usually 60 to 65 percent in stocks and the balance in bonds-diversity in true sense with portfolio containing top stocks and bonds for a blend of growth and safety. Going by the objective, a balanced mutual fund has to perform even in distressed times. Best performing balanced mutual funds are those that tide over the circumstances by actively managing the asset to maximize growth and provide regular income.

Index fund

Another variant is index fund. It is a type of mutual fund with a portfolio constructed to match or track the components of a market index, such as the Sensex or Nifty to mirror specific stock market indices. Its primary advantage is said to provide broad market exposure, low operating expenses and low portfolio turnover. "Indexing" is a passive form of fund management that has been successful in outperforming most actively managed mutual funds. Whether actively managed (equity fund) or passively indexed, this category of funds is not immune to risk which is associated with the investments made.

Exchange-traded funds

A relatively recent innovation, the exchange-traded fund (ETF) is often structured to combine the characteristics of both open-ended funds, closed-end funds and index fund. ETFs are traded throughout the day on a stock exchange, and shares are issued or redeemed by institutional investors in large blocks. Most investors purchase and sell shares through brokers in market transactions. Because the institutional investors normally purchase and redeem in kind transactions, ETFs are more efficient than traditional mutual funds (which are continuously issuing and redeeming securities and, to effect such transactions, continually buying and selling securities and maintaining liquidity positions) and therefore tend to have lower expenses.

Exchange-traded funds are also valuable for foreign investors who are often able to buy and sell securities traded on a stock exchange, subject to meeting SEBI's guidelines.

Special Schemes

In addition, special plans for tax saving (ELSS) with three years lock-in period and sector specific schemes are also offered to meet the market demand. A recent development in Indian Mutual Fund industry is to combine investment and insurance under 'unit linked insurance plan' offering investors superior return along with security, taking benefits of taxation policy to reduce tax liabilities. The fund regulators being divided whether it would come under the purview of mutual fund, the status remains uncertain and the matter is to be decided by the Apex Court.

Advantages Vs Disadvantages

Mutual funds offer several advantages over investment by any individual especially small investors. The advantages of mutual funds are professional management, diversification, economies of scale, simplicity and easy liquidity. Investors benefit by having professional fund managers who dedicate time, apply expertise and research investment options for managing public money. The fund manager invests judiciously in a blend of equity and debt as per investor's needs including equity investment in a group of stocks so that the risk is minimized. The services, however, have an attached cost (management fees) in spite of performance compared to the benchmark index and it remains one of its limitations.

The disadvantages of mutual funds are high costs, over-diversification, possible tax consequences, and the inability of management to guarantee a superior return. There is also dispute over whether professional fund managers can, on an average, outperform simple index funds that mimic public indexes.

Genuine Predicament

With many options in the market and the hard earned money at stake, safety and gain is the main outlook. Market information and advertisement have a huge impact in deciding. The information is just one side of the tale and not fully reliable and usually deceptive. Confusion galore in the minds of the investors. One must keep in mind (1) A mutual fund pools investment from a group of people and invests their money in capital market instruments such as stocks, bonds, and other securities. (2) Its advantages lie in professional management, simplicity, easy liquidity; and the disadvantages high costs, over-diversification, possible tax consequences, and the inability of management to guarantee return. (3) The administrative cost of the fund is generally about 1 percent for debt fund and index fund, 2 percent for balance fund and 3 percent for equity funds. (4) Mutual funds are easy to buy and sell. One can either buy them directly from the fund company or through an agent and redemption on-line or presenting the prescribed form and the money is transferred to the account usually within two days.

Investors also need to consider a fund's performance against its peer group as well as against its index. If the fund bested its peers and its benchmark, its results would be quite impressive indeed. To add another layer of information to the evaluation, one can consider the fund's performance over a period from their statistical records and if the fund sits in the top slot over each of the comparison periods, it is likely to be a solid performer.

Handy pointers

Investment is the best option to get good returns, but the dilemma is - where to invest and on what to invest, without losing the midnight sleeps. Mutual funds today are the best option as it is not only safe but assures optimal return. But before investing one must be cautious and take the following useful tips into consideration:

- Evaluate the need, i.e. regular income, short-term trading for gains, long-term growth,
- Determine a suitable time frame for investment and evaluate return from risk-free/risk investment,
- Divide the investible money into a basket, to avoid putting all eggs in one basket,
- Consider investment through systematic investment plan (SIP) option extended over a period that takes care of the volatility of the Indian stock market,
- As the learned warn "Never put all the eggs in one basket", and
- Decide a balance mix of funds from high performing schemes.