Myths, Risks, Advantages, and More

Mutual Funds Turned Inside Out

At this point if most of your investments are in your savings account or a fixed deposit, and your biggest asset so far is your home, then you are in the majority. Like you, most small- and middle-income investors, especially salaried individuals, rarely invest in stocks or mutual funds. The primary reason is the lack of knowledge and preconceived notions about the risk of losing the investment. This article is our attempt to collate essential factual information on alternative and contemporary investment options that general consumers may look at. The idea is to explain the significance and operative model of mutual funds as well as rebuff several myths for the average consumer in order to help them make sound investment decisions.

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Mutual funds were conceptualized to make investments in stocks a bit easy, with the option of buying and selling stocks with small amounts as and when one wants. Basically, your small investment in a mutual fund is clubbed with other such small investments to make it a large pool of investment in various securities. The fund is appropriately named mutual fund since all investors 'mutually' share the fund's gains as well as losses on an equal basis, proportionately to the amount they invest.

Interestingly, you can diversify your investment portfolio across a large number of securities, thereby minimizing the risk of major loss. You need not worry about fluctuations in individual securities in the fund's portfolio.

Mutual funds have many options for portfolio holding

Systematic transfer plan (STP)

In STP, you invest a lump-sum amount in some mutual fund and then a fixed sum is transferred from that mutual fund to another mutual fund.

Systematic withdrawal plan (SWP)

If a mutual fund investor redeems the units every month and gets the same deposited in their bank account, it is called SWP. The plan is recommended to liquidate the mutual funds corpus after one sees a good bull market.

Systematic investment plan (SIP)

SIP is a way of investing in mutual funds on monthly basis wherein a fixed amount goes from your bank account to the mutual funds.

Fixed maturity plan (FMP)

They are the equivalent of a fixed deposit in a bank, though with a caveat (stipulation). The maturity amount of a fixed deposit in a bank is not 'guaranteed' but only 'indicated' in the FMP of a mutual fund. The regulator does not allow fund companies to guarantee returns, and hence the 'indicated returns' in FMPs. FMPs are debt schemes and are generally open for two to three days with minimum investment set at about Rs 5,000. The prevalent yield minus the expense ratio (that varies from 0.25 per cent to 1 per cent) will be the indicative return that can be expected from the FMP.

INVESTMENT MODEL AND TYPES

The fund is usually invested in various equities, bonds and debentures, depending on the objective and the terms of scheme floated by the company offering the mutual fund. Some funds invest in gold or other assets too.

An average or a novice investor is often confused about the various kinds of mutual funds and is generally not sure where to invest. However, if one makes the effort to read a bit more and talk to a few advisors, they will be able to differentiate between various types of mutual funds. Going by what market insiders say, mutual fund investments are one of the best ways to supplement your retirement savings, especially if you are at the threshold of around 30 years of age. Let us take a look at the various types of funds floating in the market.

Aggressive Growth (Cumulative Returns)

Aggressive growth investment implies that you are buying into stocks that have a chance for dramatic growth and may gain value. It is a great option for investors who can invest for the long term. It is recommended that you do not choose this option if you are looking to conserve capital; you may go ahead if you can afford to potentially lose the value of your investment.

Aggressive growth generally results in high returns. The fund portfolio is a mix of large, medium and small companies. The fund portfolio chooses to invest in stable, well-established, blue-chip

companies, together with a small portion in small and new businesses. The fund manager picks stocks of companies that will use their profits to grow rather than to pay out dividends. It is a medium- to long-term commitment.

From the performance point of view, long-term investments in growth funds are beneficial. The fund may seem volatile over the years, so you need to be prepared for some risk and be patient.

Growth and Income Fund (Also Known As Balanced Funds)

They have a mix of goals. They seek to provide investors with current income while offering the potential for growth. They are able to achieve multiple objectives that may be exactly what you are looking for. Growth and income funds have a low-to-moderate stability along with a moderate potential for current income and growth. You need to be able to assume some risk to be comfortable with this type of fund objective.

Income Fund (Dividend Earning)

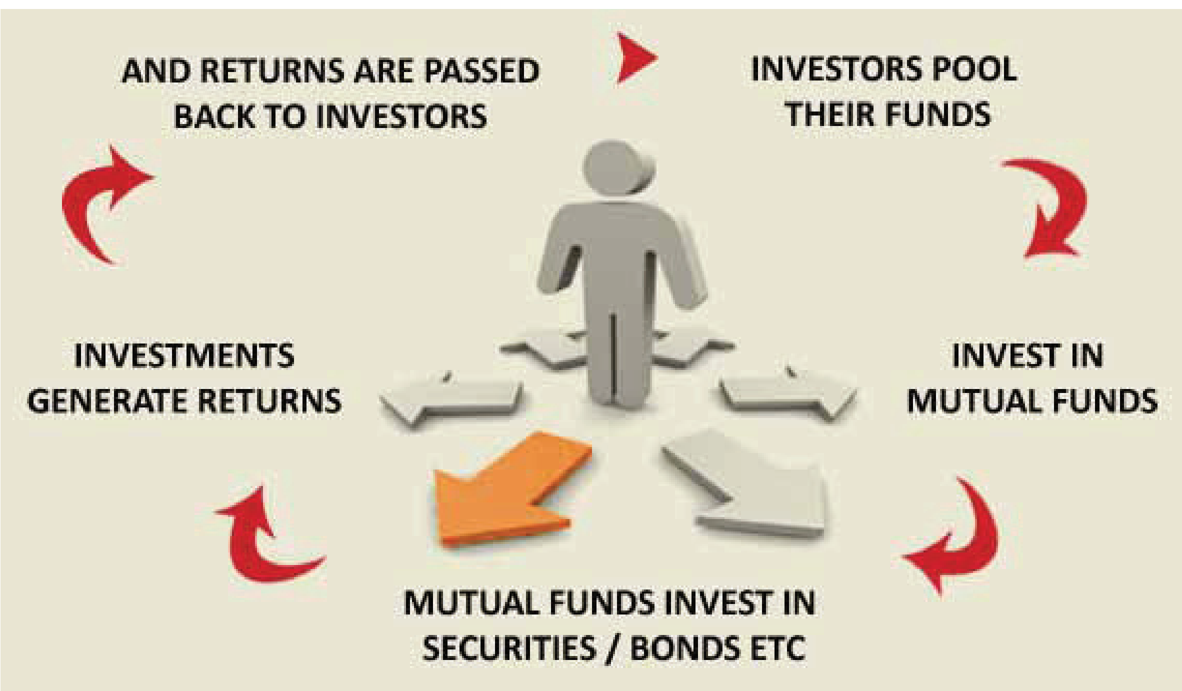
These funds will generally invest in a number of fixed-income securities. This will provide you with regular income. Retired investors can benefit from this type of fund as they will receive regular dividends. The fund manager buys debentures, company fixed deposits, etc., in order to provide you with a steady income. Even though this is a stable option, it does have some risk involved in relation to market fluctuation.

Closed-End Fund

A closed-end fund has a fixed number of shares outstanding and operates for a fixed duration (generally ranging from three to fifteen years). The fund is open for subscription only during a specified period and there is an even balance of buyers and sellers – so someone would have to be selling so that you are able to buy one. Closed-end funds are also listed on the stock exchange and so these are traded just like other stocks on an exchange or over the counter. Usually the redemption is also specified, which means that they terminate on specified dates when the investors can redeem their units.

Open-End Fund

An open-end fund is available for subscription throughout the year and is not listed on the stock exchanges. The majority of mutual funds are open-end funds. Investors have the flexibility to buy or sell any part of their investment at any time at a price linked to the fund's net asset value (NAV).



FUND SCHEMES

◆ *Equity Fund*

Unlike debt funds, you have absolutely no assurance whatsoever on the principal, rate of interest or tenure when investing in equity funds. When you invest in equity, you are considered as the owner of the particular company that you have invested in, to the extent of your investment. So, naturally, like any owner, your profit is linked with the performance of the company. The higher the profits of the company, the better are the unit price and your gains.

As equity mutual funds have the potential to give very high returns but carry high risk, they are best suited to young investors who can withstand short-term volatility to earn long-term gains. According to market experts, equity funds should be the instrument of choice for young investors who have 25–30 years to build a permanent kitty.

As with any high-risk action, equity funds carry the potential to deliver high returns. In order to help counter this risk, mutual funds are invested in multiple companies that usually do not belong to same or correlated sectors. This is known as diversifying.

In the long run, one needs to be guarded against inflation and in the short run, market fluctuations. Equity, though volatile, has proved to be a better bet against inflation, provided one has a long-term investment. An additional advantage of investing in equity funds is that the gains are tax-free.

EQUITY FUND TYPES

- *Large-cap funds*

  More than 80 per cent investments happen in large-cap companies, ensuring better returns and providing a cushioning effect even if the stock indices fall sharply.

- *Large- and mid-cap funds*

  In this, 60 per cent to 80 per cent of investments get invested in large-cap companies. Any drastic fall in stocks have a marginal effect on investment.

- *Mid- and small-cap funds*

  Here, at least 60 per cent of investment is in small- and mid-cap companies. Any sharp fall in stock indices will have direct impact, but when the fund grows, it grows exponentially.

- *Tax (planning) funds*

  These funds normally have a specific lock-in period (three years, for example, unless converted into an open-ended fund), after which they can be traded. Further purchases can be made anytime during the lock-in period. These funds give the tax benefit of a rebate u/s 80C of the Income Tax Act.

- *Infrastructure funds*

  These funds are exclusively for investment in the realty sector where there is a long gestation period due to project structure, before they start giving you returns, depending upon the fund house's brand value and the completion of projects on time as well as selling the building units to public/corporate entities.

- *International funds*

  These funds attract investments outside the country (abroad) of more than 65 per cent.

- *Equity-linked savings scheme (ELSS)*

  In this, you can grow your money by investing in the equity market as well as avail tax deduction under Section 80C of the Income Tax Act and get tax-free dividends. In some ELSS funds, there could be a lock-in period of three years.

◆ ***Debt Funds*** (also called **Income Funds**)

These funds are of investments whose average maturity varies according to objectives stated in the fund offer prospectus. Debt mutual funds work on the borrowing model.

The conditions of borrowing include:

a) Reasonable assurance that the principal and the investment will be returned

b) The interest that will be generated is based on the rate of interest (also known as the coupon rate)

c) The tenure or the time over which the principal will be returned

It is known that companies, state governments and even the central government require money to run their operations. They offer various debt-based instruments like treasury bills, debentures, government securities (G-Sec) etc., and mutual funds buy the debt that is issued by them.

Debt funds help bring stability to your investment portfolio since they are lower in risk as compared to equity funds. However, these are riskier than liquid funds and their aim itself is to generate steady returns while preserving your capital.

These would typically invest in government securities, non-convertible debentures (NCD), certificates of deposit (CDs), commercial papers (CP), bonds and other fixed-income securities as well as lend money to large organizations or corporate groups, in return of a fixed interest rate. Therefore, investing in debt mutual funds would be ideal if you are looking at a potentially higher return than liquid funds over a medium-term time horizon, between 3 months and 2 years.

Debt funds are further classified into debt-oriented aggressive funds wherein the average equity exposure is between 25 per cent and 60 per cent, and debt-oriented conservative funds where the average equity exposure is less than 25 per cent. Hence, returns could be modest and the holding has to be for a longer period (3 to 5 years) to get better returns.

◆ ***Liquid Funds***

In financial terms, the word 'liquid' simply means 'how fast you can get your invested money back.' A highly liquid asset is as good as hard cash. Liquid funds have the least risk factor and may give you returns that are slightly higher than that of a savings account. These funds invest in faster maturing debt securities, making them less risky. The concept here is that the closer the debt instrument is to its maturity, the higher are the chances of getting the principal and the interest.

◆ ***Hybrid Funds***

As the name suggests, hybrid funds have a combination of asset classes such as debt and equity in their portfolio as they invest in a blend of debt, money-market instruments and equity.

◆ ***Diversified Funds*** (also called **Balanced Funds**)

If one is averse to taking risks in equity market investment, they should choose the balanced fund, where the equity exposure is lower.

◆ ***Gilt Funds***

Gilt Funds are mutual funds that invest only in government securities. They are preferred by risk-averse and conservative investors who wish to invest in the shadow of secure government bonds. Since gilt funds invest only in government bonds, investors are protected from credit risk.

SAVINGS ACCOUNT VERSUS LIQUID FUND

There is no doubt that a savings account is by far the best option for emergency funds. As the name suggests, savings account offers the highest liquidity since you can access your balance at any time directly through the bank or through ATM. But if you are left with funds that are in excess of emergency funds, then liquid funds are good options. They endeavour to give you your money back the very next working day, subject to the receipt of a valid redemption request. In fact, liquid funds can be used for investments ranging from a day up to one month or two months.

◆ *Money Market Funds*

The most cautious investor should opt for the money market mutual fund which aims at maintaining capital preservation. It indicates that gains will not be an option even though the interest rates given could be higher than that of bank deposits. These funds will pose very little risk but will also not protect your initial investments' buying power. Inflation will eat up the buying power over the years when your money is not keeping up with inflation rates. They are, however, highly liquid and so you will always be able to alter your investment strategy.

◆ *Sector-Specific/Thematic Funds*

These are for investing in sector-specific (cement, iron & steel, etc.) funds. Sector-specific funds aim to invest their entire corpus in one to three sectors. These sectors are closely related to one another.

A thematic fund, on the other hand, does not hug just one sector. It invests across sectors that are woven around a common theme. Some themes around which these funds have worked are infrastructure and rural India. These companies may work in different industries but are part of a common theme.

◆ *Index Funds*

Index funds are equity funds that replicate a particular equity index by investing in the stocks that the index tracks. If you want to invest in equity mutual funds but are not confident about the abilities of the fund managers, index funds are a good option for you.

Advantages and Disadvantages of Mutual Funds

Advantages	Disadvantages
• Funds are flexible, liquid, transparent and mostly safe • Funds help you diversify • Funds reduce the transaction cost • Dividends give you income-tax benefits • Professional management is available • Explicit investment goals • Simple reinvestment programmes	• Many funds charge hefty fees, leading to lower overall returns • Over a period of time, statistics have shown that most actively managed funds tend to under-perform their benchmark averages • Mutual funds cannot be bought or sold during regular trading hours in a stock exchange, but instead are priced once per day • Many a times, the track record of the manager decides the success of the fund. Change of manager can undo the previous decisions by a faulty mix of investments, causing the fund's downfall

CV Weightage (criteria) Points 100		15	15	10	
Fund	Year Estd	Fund Grading	Net Assets	NAV	
Equity Funds			(Rs, in Crore)	(Rs)	
UTI Equity	1992	5* (15)	3,378.59 (13)	97 (5)	
ICICI Prudential Focused Bluechip	1998	5* (15)	7,108.7 (15)	28 (3)	
HDFC Top 200	1996	4* (10)	12,800.23 (15)	349 (10)	
UTI Opportunities	2005	5* (15)	4,701.76 (15)	47 (3)	
Franklin India Prima Plus	1994	4* (10)	2,761.97 (10)	405 (10)	
ICICI Prudential Dynamic – Regular Plan	2002	5* (15)	4,995.89 (15)	185 (7)	
Franklin India High Growth Companies	2007	5* (15)	810.23 (3)	27 (3)	
L&T India Special Situations	2006	4* (10)	74.44 (3)	33 (3)	
Franklin India Smaller Companies	2006	5* (15)	1,072.47 (5)	34 (3)	
UTI Mid Cap	2004	4* (10)	1,361.2 (5)	72 (5)	
ICICI Prudential Value Discovery – Regular	2004	5* (15)	6,062.78 (15)	105 (7)	
HDFC Mid-Cap Opportunities	2002	4* (10)	6,642.99 (15)	34 (3)	
Reliance Tax Saver	2005	5* (15)	2,978.56 (10)	44 (3)	
ICICI Prudential Tax Plan – Regular	1999	5* (15)	2,168.03 (10)	263 (10)	
ICICI Prudential Balanced – Regular	1999	5* (15)	996.94 (3)	87 (5)	
HDFC Balanced	2000	4* (10)	2,018.36 (10)	102 (7)	
DEBT FUNDS					
Birla Sun Life Dynamic Bond – Retail	2004	4* (10)	8,666.55 (15)	23 (3)	
Franklin India Income Builder	1997	4* (10)	1,415.55 (5)	46 (3)	
Tata Dynamic Bond – A	2003	4* (10)	320.03 (3)	20 (3)	
Birla Sun Life Medium Term	2009	4* (10)	3,307.08 (13)	16 (3)	
Reliance Regular Savings – Debt	2005	4* (10)	4,807.07 (15)	18 (3)	

Notes:

a) NAV of the funds is as of 16/17 November 2014.

b) The establishment of the fund is shown as per the year in which it was started.

15	20	10	10	5	Grand Total 100
Risk Rating	Returns (5 Years)	Returns Rating	Expense Ratio	Exit Load	
	(%)		(%)	(%)	
Low (15)	**16.95 (15)**	High (10)	2.13 (5)	1 (2)	80
Low (15)	**17.56 (15)**	High (10)	2.23 (5)	1 (2)	80
High (5)	**15.19 (10)**	Above average (5)	2.24 (5)	1 (2)	62
Low (15)	**16.72 (15)**	High (10)	2.19 (5)	1 (2)	80
Below average (5)	**17.63 (15)**	Above average (5)	2.31 (5)	1 (2)	62
Below average (5)	**17.31 (15)**	Above average (5)	2.23 (5)	1 (2)	69
Average (10)	**19.75 (15)**	High (10)	2.64 (3)	1 (2)	61
Below average (5)	**17.38 (15)**	High (10)	2.68 (3)	1 (2)	51
Below average (5)	**24.43 (20)**	High (10)	2.72 (3)	1 (2)	63
Average (10)	**24.20 (20)**	High (10)	2.75 (3)	1 (2)	65
Low (15)	**23.61 (20)**	Above average (5)	2.28 (5)	1 (2)	84
Low (15)	**24.63 (20)**	Above average (5)	2.42 (5)	1 (2)	75
High (5)	**22.65 (20)**	High (10)	2.33 (5)	0 (5)	73
Below average (5)	**19.44 (15)**	High (10)	2.46 (5)	0 (5)	75
Below average (5)	**18.51 (15)**	Above average (5)	2.64 (3)	1 (2)	53
Below average (5)	**19.58 (15)**	Above average (5)	2.30 (5)	1 (2)	59
Average (10)	**8.84 (5)**	Above average (5)	1.18 (10)	1 (2)	60
Average (10)	**9.19 (5)**	Above average (5)	1.91 (5)	0.5 (3)	48
Average (10)	**8.26 (5)**	Above average (5)	1.70 (5)	0.5 (3)	46
Below average (5)	**9.50 (5)**	Above average (5)	1.46 (10)	2 (0)	51
Low (15)	**8.31 (5)**	Above average (5)	1.85 (5)	1 (2)	62

c) The fund grading (four stars/five stars) is based on ET Wealth/Value research site.

d) Before investing, kindly verify whether any lock-in period is prescribed in the information prospectus.

CV Recommendations from Investment Point of View

EQUITY FUNDS

Best Fund
ICICI Prudential Value Discovery

Good Funds
UTI Equity
ICICI Prudential Focused Blue Chip
UTI Opportunities

DEBT FUNDS

Best Fund
Reliance Regular Savings Debt

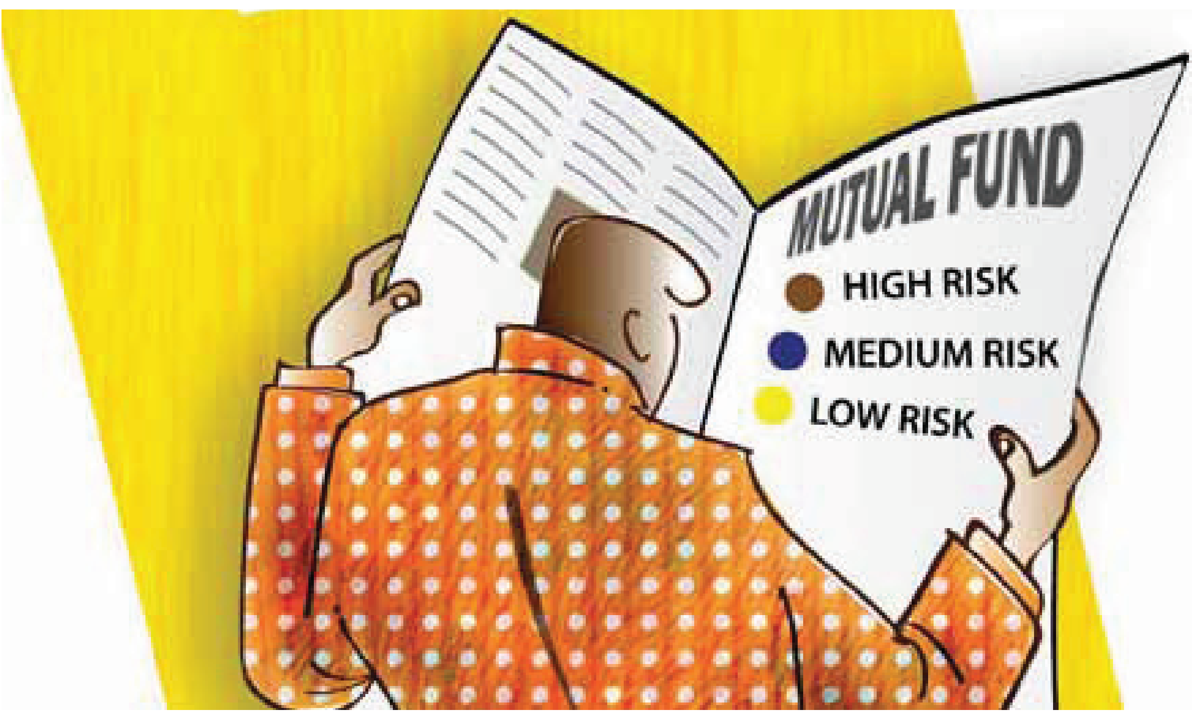
Good Fund
Birla Sun Life Dynamic Bond Retail

We have chosen and evaluated funds based on the following parameters:

a) Returns over a period of five years
b) Assets under management revised at periodical intervals
c) Fund grading (based on The *Economic Times* Wealth-Value research rating) that changes periodically
d) Net asset value that changes on daily basis based on market fluctuations
e) Expense ratio (the less the better – this means that the fund is managed well and is friendly to the investor)
f) Risk rating (at the time of making the investment)
g) Returns rating (fund returns)
h) Exit load (at the time of exiting the fund after the prescribed holding period as mentioned in the prospectus), as this varies from one fund to another depending upon the holding period

Points for Identified Variables

Team *Consumer Voice* studied all products and awarded points to each identified variable on the basis of their significance and the influential factors that an investor may consider before buying them. The recommendations by *Consumer Voice* are for certain chosen funds (see table) and do not speak for all funds in the mutual funds portfolio.



MYTHS ABOUT MUTUAL FUNDS

- ***Myth 1: Funds are only for the long term.***

Yes, long-term investments have a slight advantage, but that does not mean that mutual funds are only for such investors. In fact, there are various short-term schemes where you can invest for one day to a few weeks.

- ***Myth 2: Mutual fund is an equity product.***

People usually associate mutual funds with equity funds, but this is not entirely true. Mutual funds invest in a variety of instruments ranging from equity to debt. Within debt, they may invest in debt instruments that mature in a day (also known as money market instruments), to those that mature in 1 year to 10 years.

- ***Myth 3: Funds with a lower net asset value are better than those with high NAV.***

The fact is that what matters is the percentage return on invested funds. So, instead of concentrating on a low NAV and more number of units, it is worthwhile to consider other factors like the performance track record, fund management and volatility that determine the portfolio return.

- ***Myth 4: One needs a large sum to invest.***

This is one of the most long-standing myths that have absolutely no relevance. Most funds allow investments as low as Rs 1,000, with no limits on the maximum amount. In fact, even for equity-linked savings schemes the amount is as low as Rs 500. Also, there is no monthly or annual maintenance charges even if you do not transact any further. Mutual funds also offer systematic investment plan facility in many of their schemes, allowing you to invest small amounts of your choice regularly.

- ***Myth 5: One needs to have a demat account.***

This is not true. There are multiple ways in which you can buy mutual funds and some of these are explained here.

(i) Offline (by filling up a form through financial intermediaries like independent financial advisors, banks, financial distribution houses, etc.)

(ii) Online: Through the many accessible distributor websites as well as through asset management companies (mutual fund companies) on their websites

If you have a demat account, you can even consolidate the mutual fund holdings along with other holdings in the demat account. You can buy mutual funds through the same intermediary who may be helping you to buy and sell shares on the stock exchange.

- ***Myth 6: Funds with a higher NAV reach the peak.***

This is a very common misconception because of the general association of mutual funds with company shares. Remember that mutual funds invest in shares, so they can get in and get out whenever the fund manager deems appropriate. If the fund manager feels that a stock has peaked, he can choose to sell it.

To understand the reality of this myth better, you need to understand that the NAV is nothing but a reflection of the market value of the shares held by the fund on any day. In all probability, the NAV could be high on account of a good performance over the years.