Mutual Fund (PUN008)

A mutual fund is a pool of money managed by a professional Fund Manager, it is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities. And the income / gains generated from this collective investment is distributed proportionately amongst the investors after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. Simply put, the money pooled in by a large number of investors is what makes up a Mutual Fund, here's a simple way to understand the concept of a Mutual Fund Unit. Let's say that there is a box of 12 chocolates costing ₹40. Four friends decide to buy the same, but they have only ₹10 each and the shopkeeper only sells by the box. So, the friends then decide to pool in ₹10 each and buy the box of 12 chocolates. Now based on their contribution, they each receive 3 chocolates or 3 units, if equated with Mutual Funds and how do you calculate the cost of one unit? Simply divide the total amount with the total number of chocolates: 40/12 = 3.33. So if you were to multiply the number of units (3) with the cost per unit (3.33), you get the initial investment of ₹10, this results in each friend being a unit holder in the box of chocolates that is collectively owned by all of them, with each person being a part owner of the box, next let us understand what is "Net Asset Value" or NAV. Just like an equity share has a traded price, a mutual fund unit has Net Asset Value per Unit. The NAV is the combined market value of the shares, bonds and securities held by a fund on any particular day (as reduced by permitted expenses and charges). NAV per Unit represents the market value of all the Units in a mutual fund scheme on a given day, net of all expenses and liabilities plus income accrued, divided by the outstanding number of Units in the scheme.

Mutual funds are ideal for investors who either lack large sums for investment, or for those who neither have the inclination nor the time to research the market, yet want to grow their wealth. The money collected in mutual funds is invested by professional fund managers in line with the scheme's stated objective. In return, the fund house charges a small fee which is deducted from the investment. The fees charged by mutual funds are regulated and are subject to certain limits specified by the Securities and Exchange Board of India (SEBI). India has one of the highest savings rates globally. This penchant for wealth creation makes it necessary for Indian investors to look beyond the traditionally favoured bank FDs and gold towards mutual funds. However, lack of awareness has made mutual funds a less preferred investment avenue, Mutual funds offer multiple product choices for investment across the financial spectrum. As investment goals vary – post-retirement expenses, money for children's education or marriage, house purchase, etc. – the products required to achieve these goals vary too. The Indian mutual fund industry offers a plethora of schemes and caters to all types of investor needs, Mutual funds offer an excellent avenue for retail investors to participate and benefit from the uptrends in capital markets. While investing in mutual funds can be beneficial, selecting the right fund can be challenging. Hence, investors should do proper due diligence of the fund and take into consideration the risk-return trade-off and time horizon or consult a professional investment adviser. Further, in order to reap maximum benefit from mutual fund investments, it is important for investors to diversify across different categories of funds such as equity, debt and gold. While investors of all categories can invest in securities market on their own, a mutual fund is a better choice for the only reason that all benefits come in a package.

Mutual Fund schemes: Mutual Fund schemes could be 'open ended' or close-ended' and actively managed or passively managed. An open-end fund is a mutual fund scheme that is available for subscription and redemption on every business throughout the year, (akin to a savings bank account, wherein one may deposit and withdraw money every day). An open-ended scheme is perpetual and does not have any maturity date. A closed-end fund is open for subscription only during the initial offer period and has a specified tenor and fixed maturity date (akin to a fixed term deposit). Units of Closed-end funds can be redeemed only on maturity (i.e., pre-mature redemption is not permitted). Hence, the Units of a closed-end fund are compulsorily listed on a stock exchange after the new fund offer, and are traded on the stock exchange just like other stocks, so that investors seeking to exit the scheme before maturity may sell their Units on the exchange. An actively managed fund is a mutual fund scheme in which the fund manager "actively" manages the portfolio and continuously monitors the fund's portfolio, deciding on which stocks to buy/sell/hold and when, using his professional judgement, backed by analytical research. In an active fund, the fund manager's aim is to generate maximum returns and out-perform the scheme's bench mark. A passively managed fund, by contrast, simply follows a market index, i.e., in a passive fund, the fund manager remains inactive or passive inasmuch as, she does not use her judgement or discretion to decide as to which stocks to buy/sell/hold, but simply replicates / tracks the scheme's benchmark index in exactly the same proportion. Examples of Index funds are an Index Fund and all Exchange Traded Funds. In a passive fund, the fund manager's task is to simply replicate the scheme's benchmark index i.e., generate the same returns as the index, and not to out-perform the scheme's bench mark.

Mutual funds come in many varieties, designed to meet different investor goals. Mutual funds can be broadly classified based on –

1. Organisation Structure – Open ended, Close ended, Interval
2. Management of Portfolio – Actively or Passively
3. Investment Objective – Growth, Income, Liquidity
4. Underlying Portfolio – Equity, Debt, Hybrid, Money market instruments, Multi Asset
5. Thematic / solution oriented – Tax saving, Retirement benefit, Child welfare, Arbitrage
6. Exchange Traded Funds
7. Overseas funds
8. Fund of funds

• **Open-ended schemes** are perpetual, and open for subscription and repurchase on a continuous basis on all business days at the current NAV.

• **Close-ended schemes** have a fixed maturity date. The units are issued at the time of the initial offer and redeemed only on maturity. The units of close-ended schemes are mandatorily listed to provide exit route before maturity and can be sold/traded on the stock exchanges.

• **Interval schemes** allow purchase and redemption during specified transaction periods (intervals). The transaction period has to be for a minimum of 2 days and there should be at least a 15-day gap between two transaction periods. The units of interval schemes are also mandatorily listed on the stock exchanges.
In an **Active Fund**, the Fund Manager is 'Active' in deciding whether to Buy, Hold, or Sell the underlying securities and in stock selection. Active funds adopt different strategies and styles to create and manage the portfolio.

- The investment strategy and style are described upfront in the Scheme Information document (offer document)
- Active funds expect to generate better returns (alpha) than the benchmark index.
- The risk and return in the fund will depend upon the strategy adopted.
- Active funds implement strategies to 'select' the stocks for the portfolio.

<u>Passive Funds:</u>

Passive Funds hold a portfolio that replicates a stated Index or Benchmark e.g. –

- Index Funds
- Exchange Traded Funds (ETFs)
- Investment holdings mirror and closely track a benchmark index, e.g., Index Funds or Exchange Traded Funds (ETFs)
- Suited for investors who want to allocate exactly as per market index.
- Lower Expense ratio hence lower costs to investors and better liquidity

In a Passive Fund, the fund manager has a passive role, as the stock selection / Buy, Hold, Sell decision is driven by the Benchmark Index and the fund manager / dealer merely needs to replicate the same with minimal tracking error.

<u>Active Fund:</u>

- Rely on professional fund managers who manage investments.
- Aim to outperform Benchmark Index
- Suited for investors who wish to take advantage of fund managers' alpha generation potential.

Liquid / Overnight / Money Market Mutual Fund:

- Liquid Schemes, Overnight Funds and Money market mutual fund are investment options for investors seeking liquidity and principal protection, with commensurate returns.
  – The funds invest in money market instruments* with maturities not exceeding 91 days.
  – The return from the funds will depend upon the short-term interest rate prevalent in the market.
- These are ideal for investors who wish to park their surplus funds for short periods.
  – Investors who use these funds for longer holding periods may be sacrificing better returns possible from products suitable for a longer holding period.
- Money Market Instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time.

Classification by Investment Portfolio: Mutual fund products can be classified based on their underlying portfolio composition
– The first level of categorization will be on the basis of the asset class the fund invests in, such as equity / debt / money market instruments or gold.
– The second level of categorization is on the basis of strategies and styles used to create the portfolio, such as, Income fund, Dynamic Bond Fund, Infrastructure fund, Large-cap/Mid-cap/Small-cap Equity fund, Value fund, etc.
– The portfolio composition flows out of the investment objectives of the scheme.

Risk Factor:

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- Mutual Fund Schemes are not guaranteed or assured return products.
- Investment in Mutual Fund Units involves investment risks such as trading volumes, settlement risk, liquidity risk, default risk including the possible loss of principal.
- As the price / value / interest rates of the securities in which the Scheme invests fluctuates, the value of investment in a mutual fund Scheme may go up or down.
- In addition to the factors that affect the value of individual investments in the Scheme, the NAV of the Scheme may fluctuate with movements in the broader equity and bond markets and may be influenced by factors affecting capital and money markets in general, such as, but not limited to, changes in interest rates, currency exchange rates, changes in Government policies, taxation, political, economic or other developments and increased volatility in the stock and bond markets.
- Past performance does not guarantee future performance of any Mutual Fund Scheme.

Specific Risk Factor: Risk of losing money: Investments in equity and equity related instruments involve a degree of risk and investors should not invest in the equity schemes unless they can afford to take the risk of possible loss of principal. **Price Risk**: Equity shares and equity related instruments are volatile and prone to price fluctuations on a daily basis. Liquidity Risk for listed securities: The liquidity of investments made in the equities may be restricted by trading volumes and settlement periods. Settlement periods may be extended significantly by unforeseen circumstances. While securities that are listed on the stock exchange carry lower liquidity risk, the ability to sell these investments is limited by the overall trading volume on the stock exchanges. The inability of a mutual fund to sell securities held in the portfolio could result in potential losses to the scheme, should there be a subsequent decline in the value of securities held in the scheme portfolio and may thus lead to the fund incurring losses till the security is finally sold. **Event Risk:** Price risk due to company or sector specific event. Debt Securities are subject to the risk of an issuer's inability to meet principal and interest payments on the obligation (Credit Risk) on the due date(s) and may also be subject to price volatility due to such factors as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity (Market Risk). The timing of transactions in debt obligations, which will often depend on the timing of the Purchases and Redemptions in the Scheme, may result in capital appreciation or depreciation because the value of debt obligations generally varies inversely with the prevailing interest rates. Interest Rate Risk Market value of fixed income securities is generally inversely related to interest rate movement. Generally, when interest rates rise, prices of existing fixed income securities fall and when interest rates drop, such prices increase. Accordingly, value of a scheme portfolio may fall if the market interest rate rises and may appreciate when the market interest rate comes down. The extent of fall or rise in the prices depends upon the coupon and maturity of the security. It also depends upon the yield level at which the security is being traded.

Credit Risk: This is risk associated with default on interest and /or principal amounts by issuers of fixed income securities. In case of a default, scheme may not fully receive the due amounts and NAV of the scheme may fall to the extent of default. Even when there is no default, the price of a security may change with expected changes in the credit rating of the issuer. It may be mentioned here that a government security is a sovereign security and is safer. Corporate bonds carry a higher amount of credit risk than government securities. Within corporate bonds also there are different levels of safety and a bond rated higher by a rating agency is safer than a bond rated lower by the same rating agency. **Spread Risk:** Credit spreads on corporate bonds may change with varying market conditions. Market value of debt securities in portfolio may depreciate if the credit spreads widen and vice versa. Similarly, in case of floating rate securities, if the spreads over the benchmark security / index widen, then the value of such securities may depreciate. **Liquidity Risk:** Liquidity risk refers to the ease with which securities can be sold at or near its valuation yield-to-maturity (YTM) or true value. Liquidity condition in market varies from time to time. The liquidity of a bond may change, depending on market conditions leading to changes in the liquidity premium attached to the price of the bond. In an environment of tight liquidity, necessity to sell securities may have higher than usual impact cost. Further, liquidity of any particular security in portfolio may lessen depending on market condition, requiring higher discount at the time of selling. The primary measure of liquidity risk is the spread between the bid price and the offer price quoted by a dealer. Trading volumes, settlement periods and transfer procedures may restrict the liquidity of some of these investments. Different segments of the Indian financial markets have different settlement periods, and such periods may be extended significantly by unforeseen circumstances. Further, delays in settlement could result in temporary periods when a portion of the assets of the Scheme are not invested and no return is earned thereon or the Scheme may miss attractive investment opportunities. At the time of selling the security, the security may become illiquid, leading to loss in value of the portfolio. The purchase price and subsequent valuation of restricted and illiquid securities may reflect a discount, which may be significant, from the market price of comparable securities for which a liquid market exists.

Counterparty Risk: This is the risk of failure of the counterparty to a transaction to deliver securities against consideration received or to pay consideration against securities delivered, in full or in part or as per the agreed specification. There could be losses to the fund in case of a counterparty default. **Prepayment Risk:** This arises when the borrower pays off the loan sooner than the due date. This may result in a change in the yield and tenor for the mutual fund scheme. When interest rates decline, borrowers tend to pay off high interest loans with money borrowed at a lower interest rate, which shortens the average maturity of Asset-backed securities (ABS). However, there is some prepayment risk even if interest rates rise, such as when an owner pays off a mortgage when the house is sold or an auto loan is paid off when the car is sold. Since prepayment risk increases when interest rates decline, this also introduces reinvestment risk, which is the risk that the principal may only be reinvested at a lower rate. **Re-investment Risk:** Investments in fixed income securities carry re-investment risk as the interest rates prevailing on the coupon payment or maturity dates may differ from the original coupon of the bond (the purchase yield of the security). This may result in final realized yield to be lower than that expected at the time. The additional income from reinvestment is the "interest on interest" component. There may be a risk that the rate at which interim cash flows can be reinvested are lower than that originally assumed.

Advantages of Mutual Fund:

1. Professional Management — Investors may not have the time or the required knowledge and resources to conduct their research and purchase individual stocks or bonds. A mutual fund is managed by full-time, professional money managers who have the expertise, experience and resources to actively buy, sell, and monitor investments. A fund manager continuously monitors investments and rebalances the portfolio accordingly to meet the scheme's objectives. Portfolio management by professional fund managers is one of the most important advantages of a mutual fund.

2. Risk Diversification — Buying shares in a mutual fund is an easy way to diversify your investments across many securities and asset categories such as equity, debt and gold, which helps in spreading the risk - so you won't have all your eggs in one basket. This proves to be beneficial when an underlying security of a given mutual fund scheme experiences market headwinds. With diversification, the risk associated with one asset class is countered by the others. Even if one investment in the portfolio decreases in value, other investments may not be impacted and may even increase in value. In other words, you don't lose out on the entire value of your investment if a particular component of your portfolio goes through a turbulent period. Thus, risk diversification is one of the most prominent advantages of investing in mutual funds

3. Affordability & Convenience (Invest Small Amounts) — For many investors, it could be more costly to directly purchase all of the individual securities held by a single mutual fund. By contrast, the minimum initial investments for most mutual funds are more affordable.

4. Liquidity — You can easily redeem (liquidate) units of open-ended mutual fund schemes to meet your financial needs on any business day (when the stock markets and/or banks are open), so you have easy access to your money. Upon redemption, the redemption amount is credited in your bank account within one day to 3-4 days, depending upon the type of scheme e.g., in respect of Liquid Funds and Overnight Funds, the redemption amount is paid out the next business day. However, please note that units of close-ended mutual fund schemes can be redeemed only on maturity. Likewise, units of ELSS have a 3-year lock-in period and can be liquidated only thereafter.

5. Low Cost — An important advantage of mutual funds is their low cost. Due to huge economies of scale, mutual funds schemes have a low expense ratio. Expense ratio represents the annual fund operating expenses of a scheme, expressed as a percentage of the fund's daily net assets. Operating expenses of a scheme are administration, management, advertising related expenses, etc. The limits of expense ratio for various types of schemes has been specified under Regulation 52 of SEBI Mutual Fund Regulations, 1996.

6. Well-Regulated — Mutual Funds are regulated by the capital markets regulator, Securities and Exchange Board of India (SEBI) under SEBI (Mutual Funds) Regulations, 1996. SEBI has laid down stringent rules and regulations keeping investor protection, transparency with appropriate risk mitigation framework and fair valuation principles.

7. Tax Benefits —Investment in ELSS up to ₹1,50,000 qualifies for tax benefit under section 80C of the Income Tax Act, 1961. Mutual Fund investments when held for a longer term are tax efficient.

Net Asset Value:

NAV stands for Net Asset Value. The performance of a mutual fund scheme is denoted by its NAV per unit.
NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on a given date. For example, if the market value of securities of a mutual fund scheme is ₹200 lakh and the mutual fund has issued 10 lakh units of ₹ 10 each to the investors, then the NAV per unit of the fund is ₹ 20 (i.e., ₹200 lakh/10 lakh). Since market value of securities changes every day, NAV of a scheme also varies on day-to-day basis. NAVs of mutual fund schemes are published on respective mutual funds' websites as well as AMFI's website daily. Unlike stocks, where the price is driven by the stock market and changes from minute-to-minute, NAVs of mutual fund schemes are declared at the end of each trading day after markets are closed, in accordance with SEBI Mutual Fund Regulations. Further, Units of mutual fund schemes under all scheme (except Liquid & Overnight funds) are allotted only at prospective NAV, i.e., the NAV that would be declared at the end of the day, based on the closing market value of the securities held in the respective schemes. A mutual fund may accept applications even after the cut-off time, but you will get the NAV of the next business day. Further, the cut-off time rules apply for redemptions too. Net asset value (NAV) is defined as the value of a fund's assets minus the value of its liabilities. The term "net asset value" is commonly used in relation to mutual funds and is used to determine the value of the assets held. According to the SEC, mutual funds and Unit Investment Trusts (UITs) are required to calculate their NAV at least once every business day.
Formula for Net Asset Value

The NAV formula: Net Asset Value = Value of Assets – Value of Lability

- Value of assets is the value of all the securities in the portfolio
- Value of liabilities is the value of all liabilities and fund expenses (such as staff salaries, management expenses, operational expenses, audit fees, etc.). The NAV is typically represented on a per-share basis. In such a case, the formula would be:

Net Asset Value = Value of Assets – Value of Lability Total Shares Outstanding

Key Takeaways

- Net asset value is the value of a fund's assets minus any liabilities and expenses.
- The NAV (on a per-share basis) represents the price at which investors can buy or sell units of the fund.
- When the value of the securities in the fund increases, the NAV increases.
- When the value of the securities in the fund decreases, the NAV decreases.
- The NAV number alone offers no insight as to how "good" or "bad" the fund is.
- The NAV of a fund should be looked at over a timeframe to assess fund performance.

Thank You…