Religare Invesco
Mutual Fund

Understanding Mutual Funds

RELIGARE Invesco Mutual Fund

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1. Mutual Fund Basics

A Mutual Fund is a trust that collects money from investors who share a common financial goal, and invest the proceeds in different asset classes, as defined by the investment objective. Simply put, mutual fund is a financial intermediary, set up with an objective to professionally manage the money pooled from the investors at large.

By pooling money together in a mutual fund, investors can enjoy economies of scale and can purchase stocks or bonds at a much lower trading costs compared to direct investing in capital markets. The other advantages are diversification, stock and bond selection by experts, low costs, convenience and flexibility.

An investor in a mutual fund scheme receives units which are in accordance with the quantum of money invested by him. These units represent an investor's proportionate ownership into the assets of a scheme and his liability in case of loss to the fund is limited to the extent of amount invested by him.

The pooling of resources is the biggest strength for mutual funds. The relatively lower amounts required for investing into a mutual fund scheme enables small retail investors to enjoy the benefits of professional money management and lends access to different markets, which they otherwise may not be able to access. The investment experts who invest the pooled money on behalf of investors of the scheme are known as '**Fund Managers**'. These fund managers take the investment decisions pertaining to the selection of securities and the proportion of investments to be made into them. However, these decisions are governed by certain guidelines which are decided by the investment objective(s), investment pattern of the scheme and are subject to regulatory restrictions. It is this investment objective and investment pattern which also guides the investor in choosing the right fund for his investment purpose.

Today, there are a variety of schemes offered by mutual funds in India, which cater to different categories of investors to suit different financial objectives e.g. some schemes may provide capital protection for the risk-averse investor, whereas some other schemes may provide for capital appreciation by investing in mid or small cap segment of the equity market for the more aggressive investor.

The diversity in investment objectives and mandates has helped to classify and sub-classify the schemes accordingly. The broad classification can be done at the asset class levels. Thus we have Equity Funds, Bond Funds, Liquid Funds, Balanced Funds, Gilt Funds etc. These can be further sub-classified into different categories like mid cap funds, small cap funds, sector funds, index funds etc.

2. How are Mutual Funds set up?

A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and Custodian. The trust is established by a sponsor or more than one sponsor who is like a promoter of a company and registered with Securities and Exchange Board of India (SEBI). The trustees of the mutual fund hold its property for the benefit of the unit holders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over the AMC. They monitor the performance and compliance of SEBI regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent.

3. Types of Mutual Fund Schemes

Mutual Fund schemes can be classified into different categories and subcategories based on their investment objectives or their maturity periods.

Mutual Fund schemes can be classified into three categories based on their maturity periods.

Open-ended funds : An open-ended fund or scheme is one that is available for subscriptions and redemptions on a continuous basis. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices which are declared on a daily basis.

Close-ended funds : A close-ended fund or scheme has a stipulated maturity period which can range from a few months to a few years, e.g. 6 months, 5 years or 7 years. i.e. fund is open for subscription only during a specified period at the time of launch of the scheme which is the New Fund Offer (NFO). Investors can invest in the scheme at the time of the NFO and thereafter, they can buy or sell the units of the scheme on the stock exchanges where the units have to be mandatorily listed.

Interval funds : These schemes are a cross between an open-ended and a close-ended structure. These schemes are open for both purchase and redemption during pre-specified intervals (viz. monthly, quarterly, annually etc.) at the prevailing NAV based prices. Interval funds are very similar to close-ended funds, but differ on the following points:-

- They are not required to be listed on the stock exchanges, as they have an in-built redemption window.
- They can make fresh issue of units during the specified interval period, at the prevailing NAV based prices.
- Maturity period is not defined.

Exchange Traded Funds : Exchange Traded Funds or ETFs are essentially Index Funds that are listed and traded on exchanges like stocks. They enable investors to gain broad exposure to indices on stock markets in India and in some cases in other countries as well. These indices, if based on certain specific sectors/themes would thus provide exposure to such sectors with relative ease, on a real-time basis and at a lower cost than many other forms of investing. For example there are ETFs that track S&P CNX Nifty, BSE Sensex etc. Gold ETF are mutual fund schemes where the underlying investment is in physical gold.

Fund of Funds : Fund of Funds (FoF) as the name suggests are schemes which invest in other mutual fund schemes. The concept is popular in markets where there are number of mutual fund offerings and choosing a suitable scheme according to one's objective is tough. Just as a mutual fund scheme invests in a portfolio of securities such as equity, debt etc.,the underlying investments for a FoF is the units of other mutual fund scheme(s), either from the same fund family or from other fund houses or from funds domiciled outside the home country (known as overseas feeder fund or fund of funds- explained in detail under section types of equity funds).

4. Classification based on investment objective

Apart from the above classification, mutual fund schemes can also be classified based on their investment objectives.

Equity Funds : Growth/ Equity oriented schemes are those schemes which predominantly invest in equity and equity related instruments. The objective of such schemes is to provide capital appreciation over the medium to long term. These types of schemes are generally meant for investors with a long-term investment horizon and with a higher risk appetite.

Type of Equity Funds

a) Diversified Funds

- Multi-Cap Funds : These funds invest across the market capitalization i.e. in large, mid and small cap companies.
- Large Cap : These funds invest predominantly in large companies. Generally, large cap companies experience a slower growth rate and have much lower risk than mid cap companies due to their size. They are also known as blue chip companies.
- Mid Cap : These funds invest predominantly in mid cap companies. Most mid cap companies experience higher growth than a large cap company.
- Small Cap : Small cap refers to a company that it is relatively new and has lower market capitalisation. Of the three, small cap companies represent the most investment risk but also the highest return potential.
- Tax Saving Fund : These funds are also known as Equity Linked Savings Schemes (ELSS). In case of ELSS schemes investment upto Rs. 1 lakh qualify for deductions under Section 80C of the Income tax Act, 1961, however, these schemes have a lock in period of 3 years.
- Equity–International : These funds invest in companies of foreign country. The investment could be specific to a country (like the China, US fund etc.) or diversified across countries/ region (like Europe, Asia etc.). By seeking exposure to foreign stocks in portfolio one can spread investment risk and achieve diversification. AMCs generally tie up with a foreign fund (called 'Underlying Fund') and in India they launch a 'Feeder Fund'. The money collected in the feeder fund is invested in the underlying fund. Sometimes AMCs also launch schemes investing directly in equity securities of international companies. In such schemes, the local investors invest in rupees for buying the units. The rupees are converted into foreign currency for investing abroad. Thus, there is an element of foreign currency risk while investing in such schemes. Also, it should be noted that tax treatment of international equity funds is similar to debt funds.
- Equity Income / Dividend Yield Schemes : Dividend yield schemes generally invest in a well-diversified portfolio of companies with relatively high dividend yield, which provides a steady stream of cash flows by way of dividend.

b) **Sector Funds :** Sector funds invest in companies in a particular sector. For example, a banking sector fund will invest only in shares of banking companies.

c) **Thematic funds :** Thematic Funds invest in line with an investment theme. For example, an infrastructure thematic fund will invest in shares of companies that are directly or indirectly related to the infrastructure sector.

d) **Arbitrage Funds :** These funds exploit arbitrage opportunities such that the risk is neutralized, but a return is earned. The arbitrage is sought by taking advantage of a price differential of the same asset between two or more markets, say, taking advantage of the mispricing between the cash and derivatives market. These funds generally have low risk-return trade-off.

Index Funds : Index Funds invests in companies that constitute the index and in the same proportion, in order to replicate a specific market index and provide a rate of return over time that will approximate or match that of the market which they are mirroring subject to tracking error.

Income/ Debt Oriented Funds : Such schemes generally invest in debt securities like Treasury Bills, Government Securities, Bonds and Debentures etc. They are considered less risky than equity schemes, but also offer lower returns.

Gilt Funds : These funds invest exclusively in Government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to changes in interest rates and other economic factors as is the case with income or debt oriented schemes.

Money Market/Liquid Funds : These funds aim to provide easy liquidity, preservation of capital and moderate income. They invest in safer short-term instruments such as certificates of deposit, commercial paper, etc. These schemes are used mainly by institutions and individuals to park their surplus funds for short periods of time. These funds are more or less insulated from changes in the interest rate in the economy and capture the current yields prevailing in the market.

Hybrid Funds

Balanced Funds : These are the funds that aim at allocating the total assets with it in the portfolio mix of debt and equity instruments. Balanced funds provide investor with an option of single mutual fund that combines both growth and income objectives, by investing in both stocks (for growth) and bonds (for income). Balanced funds are also called equity oriented funds and their tax treatment is similar to an equity fund. Their average returns and risk profile fall somewhere in between growth and debt funds.

Monthly Income Plans : These plans seek to provide regular income by declaring dividends. It therefore invests largely in debt securities. However, a small percentage is invested in equity shares to improve the scheme's yield. Monthly Income Plan are also called debt oriented hybrid schemes. 'Monthly Income' is however not assured and depends on the distributable surplus of the scheme.

Capital Protection Oriented Schemes : These are mutual fund schemes which endeavour to protect the capital invested therein through suitable orientation of its portfolio structure. The orientation towards protection of capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover etc. SEBI stipulations require these type of schemes to be close-ended in nature, listed on the stock exchange and the intended portfolio structure would have to be mandatory rated by a credit rating agency. A typical portfolio structure could be to set aside major portion of the assets for capital safety and could be invested in highly rated debt instruments. The remaining portion would be invested in equity or equity related instruments to provide capital appreciation. Capital Protection Oriented schemes should not be confused with '**Capital Guaranteed**' schemes.

5. Investment Plans/Options available to investors

Investment Plans

Direct Plan : Under direct plan investors can invest directly with a fund house where in no agent or distributor is involved and thus they can save on costs. The direct plan has a separate NAV, which is generally higher than normal or regular plan as direct plan charges lower expenses because it does not entail paying any commission to agent/distributor and thus gets reflected in the form of higher NAV.

Regular or Normal Plan : Under regular or normal plan investors can invest through an agent or distributor in order to avail their investment advice/services. The regular plan too has a separate NAV, which is generally lower than direct plan as former charges higher expenses in order to pay commission to an intermediary involved.

Investment Options

Growth Option : Under growth option, dividends are not paid out to the unit holders. Income attributable to the unit holders continues to remain invested in the scheme and is reflected in the NAV of units under this option. Investors can realize capital appreciation if any, by way of an increase in NAV of their units by redeeming them.

Dividend Payout Option : Dividends are paid out to the unit holders under this option. However, the NAV of the units falls to the extent of the dividend paid out and applicable statutory levies.

Dividend Re-investment Option : The dividend that accrues on units under option is re-invested back into the scheme at ex-dividend NAV. Hence investors receive additional units on their investments in lieu of dividends.

6. Benefits of Mutual Fund

There are two major reasons why most people around the globe are afraid to take investment decisions on their own. One of them is the lack of time to study the pros and cons of different investment opportunities and the other being lack of financial know-how. Apart from that, some financial markets have a steep entry barrier, which prevents a small ticket investor from participating in the growth of that sector. Investment needs across different category of investors are also not common. While some may settle for safety of capital, others may chase returns. There may be others who would want their capital to grow at a steady pace, while some may want to save for retirement or child's education. The need and objective of the investors are truly diverse and one financial product can't fulfill all of them. The emergence of mutual funds in the past decade as a popular investment vehicle is due to the fact that it serves broadly all categories of investors through the plethora of schemes that it offers. The benefits provided by mutual funds far outweigh its shortcomings, and has thus gained wide-spread acceptance.

Following are the key benefits of investing in mutual funds:

- **Professional Management:** Mutual funds provide the benefit of professional management as people's money is managed by experienced fund managers. Investors, who do not have time, inclination and the know-how to manage their investments, can look towards mutual funds as an alternative. It is inexpensive and is ideal for a small ticket investor.

- **Economies of scale:** The way mutual funds are structured gives it a natural advantage. The "pooled" money from a number of investors ensures that mutual funds enjoy economies of scale; it is cheaper compared to investing directly in the capital markets which involves higher charges. This also allows retail investors access to high entry level markets like real estate, and also there is a greater control over costs.

- **Diversification:** Mutual funds provide investors with the benefit of diversification across different companies and sectors. Diversification in simple terms means to spread your portfolio across different instruments, sectors, industries, companies and countries so that the overall portfolio is relatively safeguarded from downturns in one or more sectors, companies or countries. Since small investors do not have enough money to make meaningful investments across different assets, a mutual fund does the job for them.

- **Liquidity:** Open ended mutual funds provide easy liquidity and investors can buy or sell units anytime, at the prevailing NAV based prices. Close-ended schemes are listed on a stock exchange where investors can redeem their units at the prevailing market price. Interval funds which are a cross between a close-ended and an open ended structure also provide periodic liquidity option to its investors.

- **Flexibility:** There are a lot of features in a regular mutual fund scheme, which imparts flexibility to the scheme. An investor can opt for a Systematic Investment Plan (SIP), Systematic Withdrawal Plan (SWP), Systematic Transfer Plan (STP)etc. to plan his cash flow requirements as per his convenience. The wide range of schemes being launched in India by different mutual funds also provides an added flexibility to the investor to build his portfolio accordingly.

- **Convenience:** Mutual fund companies offer convenient routes to investing in their schemes. Investors can invest through the internet or mobile phone in addition to the conventional option of physically filling up an application form and submitting it. Further, as bank details are required to be submitted at the time of investment, redemptions become very convenient as an investor directly receives the proceeds in the bank account.

- **Transparency:** The mutual fund industry in India works on a very transparent basis, and various kind of information is available to their investors through fact sheets, offer documents, annual reports etc.

- **Well Regulated:** Indian Mutual Fund industry is well regulated by the Securities and Exchange Board of India (SEBI). This helps to instill confidence and provides comfort to the investors. The regulatory environment in India is quite healthy, and ensures transparency in the processes and transactions.

The best practices adopted by the industry in India have helped them win investors' confidence over the years. The ease and convenience which mutual funds offer and the different variety of schemes made available to the investors creates popularity for mutual funds, which cuts across investor classes and creates a favourable appeal.

7. Mutual Fund Myths

There are few myths and misconceptions associated with investing in mutual fund schemes. Some of these notions have faded over time, as investor awareness has increased but some continue to hold strong. It is imperative to dispel these myths as investments should not be made under wrong impressions. It can throw the best laid out financial plan out of control, and the situation can be avoided with a little bit of caution.

Lower NAV is cheaper : The most common myth that is prevalent among mutual fund investors is that of associating a scheme with a lower NAV being a better buy compared to a scheme with a higher NAV. This stems from the mind set of equating mutual fund units with equity shares of a company. NAV of a scheme is irrelevant and irrespective of whether we are investing into a fund having a low NAV or a fund with a higher NAV, the amount of investment remains the same.

Let's look at a hypothetical investment into two schemes A and B. Scheme A has a NAV of Rs 10 whereas scheme B has a NAV of Rs 200. We made equal amount of investment of Rs. 1 lakh each in both the schemes. Scheme A would come across as a cheaper buy because we got 10,000 units as against 500 units in scheme B. Now, let us assume that both the scheme returns 10 % in a month. The NAV for scheme A is Rs 11 and Scheme B has a NAV of Rs 220. The value of your investment in both the case is Rs 1,10,000. Therefore, we see that the NAV of a scheme is irrelevant, as far as generating returns is concerned. The only difference being in case of the former, the investor gets more units and in the latter, he gets lesser units. For two schemes with identical portfolio and other things remaining constant, the difference in NAV will hardly matter and both the schemes will grow at the same rate.

Regular dividends means good performance : Another popular myth which emerges due to the linkages we make between the concepts of a stock markets and mutual funds is the dividend payout mechanism. When a company pays dividend, in effect it is transferring acerta in portion of its surplus to its shareholders. Therefore a generous dividend payout policy could be considered favourable in case of a company. However, in case of mutual funds, dividends are declared out of the distributable surplus which is included in calculation of net asset value. In effect it is paying back a certain portion of net assets from our own investments. Therefore, dividends from mutual fund units don't make us any richer, as there are no additional gains to be made. The NAV of the scheme falls to the extent of the dividend payout, when a scheme pays dividend. Thus, a scheme with a high dividend payout record does not necessarily mean that it is performing well. Dividend option may prove important to plan cash flows, especially in the case of tax savings scheme which have a lock-in period and also for tax incidence.

Demat account is required for MF investments : Except in case of schemes which are listed on the stock exchange and are available on their platforms, demat account is not required to own units in a mutual fund scheme.

Past performers are the best funds to buy : Despite the disclaimers, mutual fund investors tend to invest in the top performing scheme of the last year, hoping that past performance will ensure that the scheme continues to stay at the top. Therefore, instead of chasing the top performer in the short term, it is advisable to invest in a scheme which features in the top quartile consistently over a longer period of time. In addition to past performance, the investors should also consider other factors viz. professional management, service standards etc.

Fees and Expenses : As is the case with any other business, running a mutual fund business also involves costs. The various costs incurred by a mutual fund could be associated with transactions made by investors, operating costs, marketing and distribution expenses etc. Expenses borne by the mutual fund investor can be broadly classified into two categories: - (i) The load which may be charged to the investor at the time of redemption (ii) The recurring expenses which are charged to the fund.

Loads or Sales Charges : Loads are charges which investors incur when they redeem units in a mutual fund scheme. A load charged at the time of redemption is known as 'Exit Load or Back End Load'. Asset management companies charge these loads to defray the selling and distribution expenses including commission paid to the agents/distributors.

Since August 1, 2009 entry load has been banned and therefore purchase/subscription of mutual funds happen at a price which is equal to the NAV. However, an investor is required to pay an exit load (if any) if he chooses to redeem units. This happens at a price linked to the NAV. This re-purchase price price may differ from NAV to the extent of exit load charged, if any.

Further, expenses related to New Fund Offer (NFO) are borne by the AMC / Trustee / Sponsor.

Recurring Expenses : These are costs incurred for day to day operation of a scheme. These expenses inter alia include investment management and advisory fees, trustee fees, registrar's fees, custodian's fees, Audit fees, marketing and selling expenses including agents' commission etc. Expenses exceeding the specified limit are to borne by the AMC.

The recurring expenses (including investment management fees) that can be charged to the scheme are subject to following limits (as a percentage of daily net assets):-

First Rs. 100 crores	Next Rs. 300 crores	Next Rs. 300 crores	Balance
2.50%	2.25%	2.00%	1.75%

In addition to TER within the limits specified under regulation 52 (6) of the Regulations (as specified above), the AMC may charge expenses not exceeding 0.20% of daily net assets of the scheme, towards investment & advisory fees as specified under regulation 52(2) of the Regulations and/or towards recurring expenses as specified under 52(4) of the Regulations.

Additional Distribution Expenses in case of new inflows from specified cities

In addition to total expenses ratio (TER) as specified above, the AMC will charge expenses not exceeding 0.30% of daily net assets if the new inflows in the scheme from such cities, as specified by SEBI from time to time, are at least:

(i) 30% of gross new inflows in the scheme, or;

(ii) 15% of the average assets under management (year to date) of the scheme, whichever is higher.

In case, inflows from such cities is less than the higher of (i) or (ii) of above, such expenses on daily net assets of scheme will be charged on proportionate basis in accordance with SEBI Circular vide reference no. CIR/IMD/DF/21/2012 dated September 13, 2012. The additional expenses on account of inflows from such cities charged will be credited back to the scheme in case the said inflows are redeemed within a period of one year from the date of investment. The additional expenses charged in case of inflows from such cities will be utilized for distribution expenses incurred for bringing inflows from such cities.

Brokerage and Transaction Cost: In addition to limits specified in regulation 52 (6) of the Regulations, brokerage and transaction costs incurred for the purpose of execution of trade not exceeding 0.12% of value of trade in case of cash market transaction and 0.05% of value of trade in case of derivative transactions (inclusive of service tax) will be capitalised.

Any payment towards brokerage and transaction cost for execution of trade, over and above the said limit of 0.12% for cash market transactions and 0.05% for derivatives transactions may be charged to the scheme within the maximum limit of TER as prescribed under regulation 52 of the Regulations.

The total expenses of the scheme(s) including the Investment Management and Advisory Fee shall not exceed the limits stated in Regulation 52 of the SEBI (MF) Regulations. Any expenditure in excess of the prescribed limit (including brokerage and transaction cost, if any) will be borne by the AMC/ the Trustee /Sponsors. The Mutual Funds needs to update the current expense ratios on its website within two working days mentioning the effective date of change.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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