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MUTUAL FUNDS - CONCEPTUAL STUDY

Reshma
Assistant Professor, The Crescents College of Business, Management, Janpak, Warangal, Telangana state, India.

Introduction

Sectoral funds, which were a hit with mutual fund investors during the last Bull Run, are back in vogue and are being marketed as sector exchange traded funds or sector ETFs this year. Several asset management companies are in the process of launching ETFs with sectors such as power & infrastructure, automobile, services, FMCG, metals and pharma as the underlying theme. Those marketing these funds are hoping to raise a fair amount of funds through these schemes. Regular sectoral mutual funds have generated decent returns on their portfolios with banking funds, as a category, having generated 58% returns in one year. Pharma, FMCG and technology categories of sectoral mutual funds have yielded 50%, 46% and 36%, respectively, over a one-year period. On a wider scale, flexi-cap equity funds have returned 31% over the past one year.

"Sectoral ETFs deliver benefits in line with the performance of the un-derlying sector. It gives investors a cost-effective means to participate in sectors he or she is bullish on," said Lakshmi Iyer, head, fixed income & products, Kotak Mutual Fund, which has plans to launch metals and some market cap-based ETFs in the coming months. According to Ms Iyer, sectoral ETFs provide investors an easy way to transact on the exchange and avail themselves of the benefits of knowing the near real-time prices of their fund investments.

Benchmark Mutual Fund has sought Sebi approvals to launch six ETFs with IT, FMCG, services, energy, pharma and realty as the base themes. The ETFs will be marked against CNX IT, CNX FMCG, CNX Services Sector , CNX Energy, CNX Pharma and CNX Realty indices. The minimum investment for these schemes is Rs 10,000 and in mul-tiples of Re 1 thereafter. Apart from Benchmark, UTI, Edelweiss MF, Reliance Mutual and Religare Mutual have plans to launch sector ETFs in the near term. According to senior officials at Benchmark, sectoral ETFs allow cost-effective portfolio diversification at one shot thereby reducing scrip-specific risk. It allows foreign portfolio investors and institutional investors to have wide sectoral exposure. Being listed on the exchanges — and in dematerialised format, ETFs can be traded without much of a hassle. Unlike sector-based mutual funds, there are no exit charges or loads on ETFs.

"ETFs are going to get larger in times to come. We're also open to the idea of sector ETFs and we're working on plans along the same lines," said Jaideep Bhattacharya, CMO, UTI Asset Management. According to Mr Bhattacharya, the coming months will see fund houses launching ETFs with specific regions or markets as the underlying theme. While the industry is more or less gung-ho about launching sector ETFs, voices of dissent are being heard from wealth managers and in-vestment advisors.

"ETFs follow a passive investment strategy. There are several diversified equity funds that can generate better returns than ETFs. Only ac-tive fund management can add value to investor portfolios," said a Mumbai-based wealth manager on condition of anonymity. According to investment experts, exposure to a few sectors could in-crease risk on overall fund portfolios. Investors in sector-based funds and ETFs could suffer losses when outlook turns bleak or negative.

Mutual Fund

Mutual fund is a trust that pools money from a group of investors (sharing common financial goals) and invest the money thus collected into asset classes that match the stated investment objectives of the scheme. Since the stated investment objective of a mutual fund scheme generally forms the basis for an investor's decision to contribute money to the pool, a mutual fund can not deviate from its stated objectives at any point of time.

Every Mutual Fund is managed by a fund manager, who using his investment management skills and necessary research works ensures much better return than what an investor can manage on his own. The capital appreciation and other incomes earned from these investments are passed on to the investors (also known as unit holders) in proportion of the number of units they own.

When an investor subscribes for the units of a mutual fund, he becomes part owner of the assets of the fund in the same proportion as his contribution amount put up with the corpus (the total amount of the fund). Mutual Fund investor is also known as a mutual fund shareholder or a unit holder.

Any change in the value of the investments made into capital market instruments (such as shares, debentures etc) is reflected in the Net Asset Value (NAV) of the scheme. NAV is defined as the market value of the Mutual Fund scheme's assets net of its liabilities. NAV of a scheme is calculated by dividing the market value of scheme's assets by the total number of units issued to the investors.

For example

a. If the market value of the assets of a fund is Rs. 100,000 .
b. The total number of units issued to the investors is equal to 10,000.
c. Then the NAV of this scheme = (A)/(B), i.e. 100,000/10,000 or 10.00 .
d. Now if an investor 'X' owns 5 units of this scheme
e. Then his total contribution to the fund is Rs. 50 (i.e. Number of units held multiplied by the NAV of the scheme)

Advantages of Mutual Fund

1. Portfolio Diversification Mutual Funds invest in a well-diversified portfolio of securities which enables investor to hold a diversified investment portfolio (whether the amount of investment is big or small).

2. Professional Management Fund manager undergoes through various research works and has better investment management skills which ensure higher returns to the investor than what he can manage on his own.

3. Less Risk Investors acquire a diversified portfolio of securities even with a small investment in a Mutual Fund. The risk in a diversified portfolio is lesser than investing in merely 2 or 3 securities.

4. Low Transaction Costs Due to the economies of scale (benefits of larger volumes), mutual funds pay lesser transaction costs. These benefits are passed on to the investors.

5. Liquidity An investor may not be able to sell some of the shares held by him very easily and quickly, whereas units of a mutual fund are far more liquid.

6. Choice of Schemes Mutual funds provide investors with various schemes with different investment objectives. Investors have the option of investing in a scheme having a correlation between its investment objectives and their own financial goals. These schemes further have different plans/options

7. Transparency Funds provide investors with updated information pertaining to the markets and the schemes. All material facts are disclosed to investors as required by the regulator.

8. Flexibility Investors also benefit from the convenience and flexibility offered by Mutual Funds. Investors can switch their holdings from a debt scheme to an equity scheme and vice-versa. Option of systematic (at regular intervals) investment and withdrawal is also offered to the investors in most open-end schemes.

9. Safety Mutual Fund industry is part of a well-regulated investment environment where the interests of the investors are protected by the regulator. All funds are registered with SEBI and complete transparency is forced.

Disadvantages of Mutual Fund

1.Costs Control Not in the Hands of an Investor Investor has to pay investment management fees and fund distribution costs as a percentage of the value of his investments (as long as he holds the units), irrespective of the performance of the fund.

2. No Customized Portfolios The portfolio of securities in which a fund invests is a decision taken by the fund manager. Investors have no right to interfere in the decision making process of a fund manager, which some investors find as a constraint in achieving their financial objectives.

3. Difficulty in Selecting a Suitable Fund Scheme Many investors find it difficult to select one option from the plethora of funds/schemes/plans available. For this, they may have to take advice from financial planners in order to invest in the right fund to achieve their objectives.

Types of Mutual Funds

Open-end Funds: Funds that can sell and purchase units at any point in time are classified as Open-end Funds. The fund size (corpus) of an open-end fund is variable (keeps changing) because of continuous selling (to investors) and repurchases (from

the investors) by the fund. An open-end fund is not required to keep selling new units to the investors at all times but is required to always repurchase, when an investor wants to sell his units. The NAV of an open-end fund is calculated every day.

Closed-end Funds: Funds that can sell a fixed number of units only during the New Fund Offer (NFO) period are known as Closed-end Funds. The corpus of a Closed-end Fund remains unchanged at all times. After the closure of the offer, buying and redemption of units by the investors directly from the Funds is not allowed. However, to protect the interests of the investors, SEBI provides investors with two avenues to liquidate their positions:

1. Closed-end Funds are listed on the stock exchanges where investors can buy/sell units from/to each other. The trading is generally done at a discount to the NAV of the scheme. The NAV of a closed-end fund is computed on a weekly basis (updated every Thursday)
2. Closed-end Funds may also offer "buy-back of units" to the unit holders. In this case, the corpus of the Fund and its outstanding units do get changed.

Load Funds/no-load funds

Load Funds: Mutual Funds incur various expenses on marketing, distribution, advertising, portfolio churning, fund manager's salary etc. Many funds recover these expenses from the investors in the form of load. These funds are known as Load Funds. A load fund may impose following types of loads on the investors:

- **Entry Load –** Also known as Front-end load, it refers to the load charged to an investor at the time of his entry into a scheme. Entry load is deducted from the investor's contribution amount to the fund.
- **Exit Load –** Also known as Back-end load, these charges are imposed on an investor when he redeems his units (exits from the scheme). Exit load is deducted from the redemption proceeds to an outgoing investor.
- **Deferred Load –** Deferred load is charged to the scheme over a period of time.
- **Contingent Deferred Sales Charge (CDSS) –** In some schemes, the percentage of exit load reduces as the investor stays longer with the fund. This type of load is known as Contingent Deferred Sales Charge.

No-load Funds: All those funds that do not charge any of the above mentioned loads are known as No-load Funds.

Tax-exempt Funds/ Non-Tax-exempt Funds:

Tax-exempt Funds: Funds that invest in securities free from tax are known as Tax-exempt Funds. All open-end equity oriented funds are exempt from distribution tax (tax for distributing income to investors). Long term capital gains and dividend income in the hands of investors are tax-free.

Non-Tax-exempt Funds: Funds that invest in taxable securities are known as Non-Tax-exempt Funds. In India, all funds, except open-end equity oriented funds are liable to pay tax on distribution income. Profits arising out of sale of units by an investor within 12 months of purchase are categorized as short-term capital gains, which are taxable. Sale of units of an equity oriented fund is subject to Securities Transaction Tax (STT). STT is deducted from the redemption proceeds to an investor

Broad Mutual Fund Types

1. **Equity Funds:** Equity funds are considered to be the more risky funds as compared to other fund types, but they also provide higher returns than other funds. It is advisable that an investor looking to invest in an equity fund should invest for long term i.e. for 3 years or more. There are different types of equity funds each falling into different risk bracket. In the order of decreasing risk level, there are following types of equity funds:

a. **Aggressive Growth Funds -** In Aggressive Growth Funds, fund managers aspire for maximum capital appreciation and invest in less researched shares of speculative nature. Because of these speculative investments Aggressive Growth Funds become more volatile and thus, are prone to higher risk than other equity funds.

b. **Growth Funds -** Growth Funds also invest for capital appreciation (with time horizon of 3 to 5 years) but they are different from Aggressive Growth Funds in the sense that they invest in companies that are expected to outperform the market in the future. Without entirely adopting speculative strategies, Growth Funds invest in those companies that are expected to post above average earnings in the future.

c. **Speciality Funds -** Speciality Funds have stated criteria for investments and their portfolio comprises of only those companies that meet their criteria. Criteria for some speciality funds could be to invest/not to invest in particular regions/companies. Speciality funds are concentrated and thus, are comparatively riskier than diversified funds.

d. There are following types of speciality funds:

2. Sector Funds: Equity funds that invest in a particular sector/industry of the market are known as Sector Funds. The exposure of these funds is limited to a particular sector (say Information Technology, Auto, Banking, Pharmaceuticals or Fast Moving Consumer Goods) which is why they are more risky than equity funds that invest in multiple sectors.

3. Foreign Securities Funds: Foreign Securities Equity Funds have the option to invest in one or more foreign companies. Foreign securities funds achieve international diversification and hence they are less risky than sector funds. However, foreign securities funds are exposed to foreign exchange rate risk and country risk.

4. Mid-Cap or Small-Cap Funds: Funds that invest in companies having lower market capitalization than large capitalization companies are called Mid-Cap or Small-Cap Funds. Market capitalization of Mid-Cap companies is less than that of big, blue chip companies (less than Rs. 2500 crores but more than Rs. 500 crores) and Small-Cap companies have market capitalization of less than Rs. 500 crores. Market Capitalization of a company can be calculated by multiplying the market price of the company's share by the total number of its outstanding shares in the market. The shares of Mid-Cap or Small-Cap Companies are not as liquid as of Large-Cap Companies which gives rise to volatility in share prices of these companies and consequently, investment gets risky.

5. **Diversified Equity Funds -** Except for a small portion of investment in liquid money market, diversified equity funds invest mainly in equities without any concentration on a particular sector(s). These funds are well diversified and reduce sector-specific or company-specific risk. However, like all other funds diversified equity funds too are exposed to equity market risk. One prominent type of diversified equity fund in India is Equity Linked Savings Schemes (ELSS). As per the mandate, a minimum of 90% of investments by ELSS should be in equities at all times.

6.

Equity Index Funds - Equity Index Funds have the objective to match the performance of a specific stock market index. The portfolio of these funds comprises of the same companies that form the index and is constituted in the same proportion as the index. Equity index funds that follow broad indices (like S&P CNX Nifty, Sensex) are less risky than equity index funds that follow narrow sectoral indices (like BSEBANKEX or CNX Bank Index etc). Narrow indices are less diversified and therefore, are more risky.

7. Debt/IncomeFunds: Funds that invest in medium to long-term debt instruments issued by private companies, banks, financial institutions, governments and other entities belonging to various sectors (like infrastructure companies etc.) are known as Debt / Income Funds. Debt funds are low risk profile funds that seek to generate fixed current income (and not capital appreciation) to investors. In order to ensure regular income to investors, debt (or income) funds distribute large fraction of their surplus to investors. Although debt securities are generally less risky than equities, they are subject to credit risk (risk of default) by the issuer at the time of interest or principal payment. To minimize the risk of default, debt funds usually invest in securities from issuers who are rated by credit rating agencies and are considered to be of "Investment Grade". Debt funds that target high returns are more risky. Based on different investment objectives, there can be following types of debt funds:

a. **Diversified Debt Funds -** Debt funds that invest in all securities issued by entities belonging to all sectors of the market are known as diversified debt funds. The best feature of diversified debt funds is that investments are properly diversified into all sectors which results in risk reduction. Any loss incurred, on account of default by a debt issuer, is shared by all investors which further reduces risk for an individual investor.
b. **Focused Debt Funds* -** Unlike diversified debt funds, focused debt funds are narrow focus funds that are confined to investments in selective debt securities, issued by companies of a specific sector or industry or origin. Some examples of focused debt funds are sector, specialized and offshore debt funds, funds that invest only in Tax Free Infrastructure or Municipal Bonds. Because of their narrow orientation, focused debt funds are more risky as compared to diversified debt funds. Although not yet available in India, these funds are conceivable and may be offered to investors very soon.

Conclusion

Mutual funds are dynamic financial intuitions which play crucial role in an economy by mobilizing savings and investing them in the capital market. The activities of Mutual funds have both short and long term impact on the savings in the capital market and the national economy. Mutual funds, trust, assist the process of financial deepening & intermediation. To banking at the same time they also compete with banks and other financial intuitions. India is one of the few countries to day maintain a study growth rate is domestic savings.