

Mutual Funds

Can You Afford to Ignore Them?

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Mutual funds are the most suitable investment option for retail investors who do not have a large investable amount and thorough know-how of the financial markets.

Silly, a retired person, invests all his moneys in 6-month bank deposits. During the last few years, each time a deposit matured, he reinvested the proceeds at lower interest rates. With declining interest income, he is eating into his corpus to meet regular living expenses.

Billy, a colleague of Silly, invested his retirement proceeds in mutual fund schemes, which in turn invested in interest bearing debt securities. His portfolio has returned over 20% p.a., during the last three years. This was possible because of the decline in interest rates—the same factor that upset Silly's plans for a peaceful retirement.

The examples of Silly and Billy show that it is no longer a question of whether people can afford to invest in mutual fund schemes. The moot question is whether they can afford not to invest in mutual funds.

What is a Mutual Fund?

A mutual fund (MF) is a vehicle to pool money from investors, with a promise that the money would be invested in a particular manner, by professional managers who are expected to honor the promise.

The idea behind a MF is that investors lack time, inclination or skills to manage their own investments. Professional managers, acting on behalf of the MF, manage the investments for the benefit of investors in return for a management fee. The organization that manages the investment is the Asset Management Company (AMC). In India, the operations of the AMC are supervised by a Board of Trustees/Trustee company.

Asset Classes

The two main asset classes are debt and equity. Popular perception is that equity is risky, while debt is safe. However, it needs to be remembered that debt

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securities are as susceptible to daily change in values as equity securities. Thus, there is a potential for capital gain or risk of capital erosion in both equity and debt. Further, the real returns on debt (i.e., returns net of inflation), may or may not be positive. Equity, on the other hand, can be an effective hedge against inflation, particularly in situations of normal inflation.

Fundamentally, value of debt securities depend on interest rates and credit risk of the borrower. Equity valuations, on the other hand, vary with corporate performance and prospects, and the overall market sentiment. Given the diversity in the factors underlying debt and equity valuation, investors normally benefit by having a mix of both asset classes. Distribution of the portfolio between asset classes is referred to as asset allocation.

Conventional wisdom is that as people age, they need to invest a higher proportion of their portfolio in debt. This is justified on two grounds: Equity values are unpredictable over short-terms, but could be more predictable over medium to long-terms, like expectations of changes in seasons being more predictable than changes in daily weather. As Benjamin Graham said, "In the short run, the market is a voting machine. In the long run, it's a weighing machine". The voting machines may be swayed by emotion—but the weighing machine will disclose the true weight. Since the investment horizon reduces with advancing age, it would be prudent to reduce equity exposures.

Older the person, lesser the time and fewer the options to recoup any losses that can occur on account of capital erosion. Thinkers like Benjamin Graham, however, held the view that age is not as important as the psychology of the investor. As such, an old investor who has the financial and psychological ability to absorb the shock of capital erosion can take significant exposures to equity.

Generally, only two asset classes, debt and equity, are factored in asset allocation frameworks. It may be appropriate to also consider investment in real estate (beyond one residential home) and gold (more so in a country like India). The well-to-do sections of society may like to include paintings, horses etc., in their investments. An increasingly active secondary market in commodities makes it a candidate for inclusion in asset classes in future.

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Classification of Schemes

First Type of Classification

Investors have their preferences on how they would like their money to be invested and the extent of risk they are willing to take. Every MF scheme caters to a group of investors having similar preferences. A MF can, and typically does, have several schemes to cater to different investor preferences. MF schemes can be offered with a range of investment objectives to meet different preferences regarding return and risk. For instance, equity schemes invest primarily in equity shares. The schemes that focus on equity shares of a single industry/sector are called sector funds. Diversified equity schemes invest in a mix of equities spread over different sectors. Debt schemes largely invest in debt securities. The schemes that focus on government securities are called gilt schemes. If investment is in debt securities that mature within a year, it is a liquid scheme. Diversified debt schemes invest in a mix of debt options of different types. Balanced schemes invest relatively significant proportions in both equity and debt securities.

Second Type of Classification

Open-end Schemes

These are schemes that do not have a fixed maturity. The MF ensures liquidity by announcing sale and repurchase price for the units of the open-end scheme on an ongoing basis. Investors who wish to exit from an open-end scheme can offer their units to the MF for redemption, generally called repurchase. Similarly, the MF can sell new units to investors desirous of participating in the scheme, generally called sale.

Closed-end Schemes

These are schemes that have a fixed maturity. Liquidity in such schemes is available through listing in the stock market.

Third Type of classification

Index Schemes

These are schemes where the fund manager has limited role. Investments are made in the same securities and in the same proportion as a pre-specified index. Thus, investments become programmable. John Bogle of the Vanguard group is credited with the view that such passive investment style is better for investors than managed schemes that charge high fees.

Managed Schemes

These are schemes where the fund manager has discretion in deciding where and how much to invest. This enhanced role is compensated through higher management fees than the charges in index schemes.

MF is a solution for investors who cannot actively manage their investment risk in individual securities. They can delegate this role to the MF, while retaining the right and the obligation to monitor their investments in the scheme (which, in turn, invests in individual securities).

Schemes and Units

Investment in a company is normally represented by a certain number of shares. People invest in a company by acquiring its shares. They disinvest by selling its shares. The parallel of shares for a company, are units for a MF scheme. Thus, investors invest in a scheme by buying its units. They disinvest by selling its units. The total outstanding units of a scheme multiplied by the face value of its units, constitutes the unit capital of the scheme. Every scheme has an investment objective or philosophy i.e., a promise by the AMC on how the funds would be managed. Investors in a scheme are essentially buying into this investment objective or philosophy.

Options and Plans under a Scheme

Every scheme has an investment portfolio. At times there is a need to differentiate between investors within the same scheme. For instance, among investors who have subscribed to a scheme's investment policy, some may prefer a regular flow of income, while others would prefer their income to grow in the scheme. Such differentiation is ensured by offering different options, for example, dividend option and growth option, under the same scheme.

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In a dividend option, the scheme declares and pays dividends to unit holders from time to time. On the other hand, a growth option does not entail a dividend. To the extent the income is not distributed, profits are retained in the scheme. The value of each unit in a growth option would, therefore, be higher than the value of each unit in the dividend option of the same scheme.

A third possible option is dividend reinvestment, where dividend is declared but not distributed to the investor. The dividend that is declared is used to buy additional units in the same scheme. Therefore, the value of each unit in a dividend reinvestment option would be similar to a comparable unit under the dividend option; but the dividend reinvestment option investor would have more number of units than a comparable growth option investor. The working, without factoring income tax, is illustrated in the accompanying table, where there is 60% growth in investment of Rs. 15,000 in each of the schemes.

The Three Investment Options						
	Dividend Option		Growth Option		Dividend Reinvestment Option	
	Units	NAV (Rs.)	Units	NAV (Rs.)	Units	NAV (Rs.)
Opening NAV before dividend declaration	1500	10.00	1500	10.00	1500	10.00
Dividend Declared (per unit)	-	16.00	-	16.00	-	16.00
Ex-Dividend NAV	-	1.00	-	N.A.	-	1.00
Dividend received by investor on his/her holding	-	15.00	-	16.00	-	15.00
Dividend re-invested by Investor	-	1500.00	-	N.A.	-	0.00
Additional Units (assuming reinvestment at ex-dividend NAV)	-	0.00	-	N.A.	-	1500.00
	-	N.A.	-	N.A.	100	-

Investor's Net Position						
	Dividend Option		Growth Option		Dividend Reinvestment Option	
	Units	NAV (Rs.)	Units	NAV (Rs.)	Units	NAV (Rs.)
Unit Holding	1500	15.00	1500	16.00	1600	15.00
Unit Holding Value		22,500.00		24,000.00		24,000.00
Add Dividend in Bank		1,500.00		0.00		0.00
Total		24,000.00		24,000.00		24,000.00

Net Asset Value

Net Asset Value (NAV) indicates the intrinsic worth of a scheme. NAV per unit represents the worth of each unit that investors hold. This is calculated by valuing the net assets of the scheme and dividing by the number of units issued under the scheme.

When there is an appreciation in the markets where a scheme has invested, net assets of the scheme would increase and, therefore, its NAV too would rise. Similarly, if the market declines, the scheme's NAV will fall.

Investing Systematically

Rather than investing, disinvesting or switching the entire portfolio at a single point of time, it is prudent to spread these actions systematically over a period of time. This approach curbs the tendency of investors to time the market, an investment style that several researchers have statistically proved as having a poor probability of success.

This principle has given rise to the concept of Systematic Investment Plan (SIP), which entails investing a constant amount regularly, generally every month. When the market goes up, the money invested in that period gets translated into fewer units for the investor. If the market goes down, then the same money invested gets translated into more units. Thus, the investor acquires units at an average cost for the period.

Similarly, investors can avoid timing the market by withdrawing constant amounts periodically (Systematic Withdrawal Plan) or systematically transferring investment between different schemes (Systematic Transfer Plan).

Money in Trust

The MF manages investments of the scheme for the benefit of its investors. Every scheme has an:

- Investment Portfolio (Portfolio Statement);
- Account of Income and Expenditure (Revenue Account); and
- Account of Assets and Liabilities (Balance Sheet).

In order to ensure fairness to investors, the expenditure that can be charged to the scheme, whether as management fees or as other expenses, is regulated by Sebi. The gains of any scheme (after accounting for income, permitted expenses, profits and losses from the investment activity) would belong to its investors. Similarly losses, if any, would need to be borne by its investors, up to the amount invested. Thus, the MF manages the money in the form of a trust for the benefit of the investors.

Benefits of Investing in MFs

Legal Comfort

MFs in India are governed by the regulations of Sebi. These are robust and help protect investors.

Choice of Risk Position

Investors can choose between different types of schemes depending on their risk preference.

Professional Management

Investment is a specialized and full-time activity. AMC's have professionals and the establishment to carry out this specialized work. Further, professional managers can take more dispassionate decisions, such as selling in a stop-loss situation, which investors find difficult on emotional grounds.

Investment Convenience

The facility of making investments through service centers as well as through the Internet ensures convenience. Similarly, through standing instructions, it is possible for investors to adopt SIP, SWP or STP.

Liquidity

Open-end schemes offer liquidity through on-going sale and repurchase facility. Thus, the investor does not have to worry about finding a buyer for his/her investment—a risk normally associated with direct investment in the securities market.

Investment Lot

Direct investment in the securities market often comes with a stiff minimum investment requirement. This is particularly so in the Indian debt market, where realistic options for retail investors are only now emerging. On the other hand, debt schemes give investors the option of investing as little as Rs. 5,000 with the added assurance of liquidity. Similarly, investors can have a diversified equity portfolio by investing a nominal amount of Rs. 5,000 in an equity scheme.

Cost Economies

Given its size, an AMC would be in a position to negotiate better brokerage terms for its sales and purchases of investments. Similarly, other costs of professionally managing the investments and the underlying risks are shared by all the unit holders, thus ensuring cost-effective investment service for investors.

Tax Efficiency

In general, investors pay tax on yearly basis. So, if they were to earn an income and then reinvest the income, they would reinvest a lower amount that is available after paying tax. MF schemes, on the other hand, do not have to pay tax on their income. Hence, the same earning in a MF scheme implies higher amount available for reinvestment.

This differential tax treatment offers an opportunity to investors to multiply their money within a scheme, without paying a tax in the interim. The incidence of taxation can be postponed until the investor needs the money—at which point of time the income can be structured as a long-term capital gain (through repurchase), which would be taxed at a lower rate of tax. Similarly, the dividends received at the hands of the investors would be exempted from tax.

Steps to MF Investing**Asset Allocation**

The most critical decision for the investor is the mix of debt and equity that he/she should have in his/her portfolio. This should be in line with his/her risk taking ability and investment horizon. As seen earlier, debt is viewed as safer than equity. According to Warren Buffett, "To invest successfully over a life time does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

Selecting MF Scheme Categories

Once allocation between the two broad asset classes is decided, investor has to get into the subclassification. For example, out of the allocation to debt, he/she has to set apart enough money in liquid schemes to meet emergencies. Liquid schemes are considered to be lowest in risk among the debt schemes, because they invest in money market securities that experience the lowest volatility in prices. Similarly, he/she needs to decide whether to invest in junk bond schemes and sector funds (appropriate for high risk investors) or gilt schemes and equity income funds (suitable for low risk investors).

Identifying Specific MF Schemes

With around 35 AMCs offering over 400 MF schemes, a wide choice of investment options is available, even within the same MF scheme categories. The website of Association of Mutual Funds in India [www.amfiindia.com] provides useful information on asset management companies and other industry information. It also provides links to each MF's website.

Investors need to select schemes based on factors such as reputation of the sponsor, AMC and fund managers, quality of portfolio, historical risk-return metrics, expense ratio etc. For equity schemes, the type of equity shares in which investment is being made becomes pertinent. Diversified schemes have a lower risk than schemes investing in only specific sectors. Portfolio turnover i.e., the number of times the portfolio is churned makes a difference in returns. Too much of churning would increase transaction costs and pull down returns.

In debt scheme, the quality of companies in which the investment would be made and the tenor of such investments are important. Longer the tenor (maturity) of the securities where the scheme invests and lower the credit rating, more would be the risk inherent in the scheme. Websites such as www.valueresearchonline.com and www.myiris.com make it convenient for investors to gather the requisite information and compare schemes to take optimal investment decisions.

Making the Investment

Investors should make sure that they only invest through qualified distributors. AMFI registration is compulsory for MF agents to distribute the schemes. Investors should convince themselves that the agent is qualified to sell. Investors who are less knowledgeable about MF schemes should seek the aid of the agent in deciding on schemes to invest or sell. For example, one needs to be clear that if today he/she invests in a debt MF scheme, he/she will not get the 20% returns that Billy earned earlier.

Review

Investment in MF schemes eliminates the headache of having to take daily investment/disinvestment decisions. Yet, the investor would need to monitor his/her positions and book profits from time to time. Similarly, he/she should keep switching from schemes that are performing poorly to the better ones.

Will

Making a will is an important aspect of any financial plan. Unfortunately, the importance of this key document is yet to be recognized. Investors should make a will that would clearly set out how their assets are to be distributed to the next generation. As the Indian financial system matures, there will be a strong body of financial planners who would advise investors on all aspects of the decision-making process.

Future Direction

A key change will be in the pension funds. The government is in the process of setting up excellent architecture for the maintenance of low-cost, convenient pension accounts by all investors. The policy framework envisages two types of accounts that can be maintained by individual members:

- Tier 1 which would be a non-withdrawable account with tax benefits.
- Tier 2 which would be like a withdrawable savings account with no tax advantages.

These accounts will be completely portable—and would be accessible in most banks and post offices. In the course of the next year or two, these pension funds would emerge as stiff competitors for the MFs, especially for low risk long-term investments that are normally a part of retirement plans of investors.

According to Samuel Case, "Most investors try various markets, lose money, and finally acquire some knowledge through bitter experience. This is roughly analogous to learning how to drive by having a series of accidents". Investors can minimize the accidents and their impact by investing prudently—taking the advice of professionals, if required. But they should remember the words of Louis Engel, "The cheapest commodity in the world is investment advice from people not qualified to give it".

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Investment Guru – William O'Neil

Job Description

Chief Executive Officer, William O'Neil and Company, an advisory firm-based in Los Angeles, California, US.

Investment Style

Growth stock trader with medium-term horizon (2-5 years).

Long-term Returns

O'Neil's track record has had its ups and downs, particularly during and just after the 'go-go' years of the 60s. But he is thought to have averaged an annual return of over 40% on his personal account in the ten years up to 1989.

Biggest Success

One of O'Neil's earliest coups was in the drug stock Syntex. The company was the first mass manufacturer of the birth control pill at the start of the 'sexual revolution'. It had just announced quarterly earnings growth of 300% when he bought the stock in 1963. As the market woke up to the potential, the price rocketed from US\$ 100 to US\$ 550 in six months, and he made enough money to set up his own business.

Key Sayings

"The whole secret to winning and losing in the stock market is to lose the least amount possible when you're not right."

"Always sell your worst stock first."

"What seems too high and risky to the majority generally goes higher and what seems low and cheap generally goes lower."

"History will repeat itself."

Source: <http://uk.biz.yahoo.com>