Investment Management
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Lecture - 23
Mutual Fund Basics (Cont.)

Hi there. So, in continuation with our discussion about mutual funds, in this session we will talk about Mutual Fund Basics.

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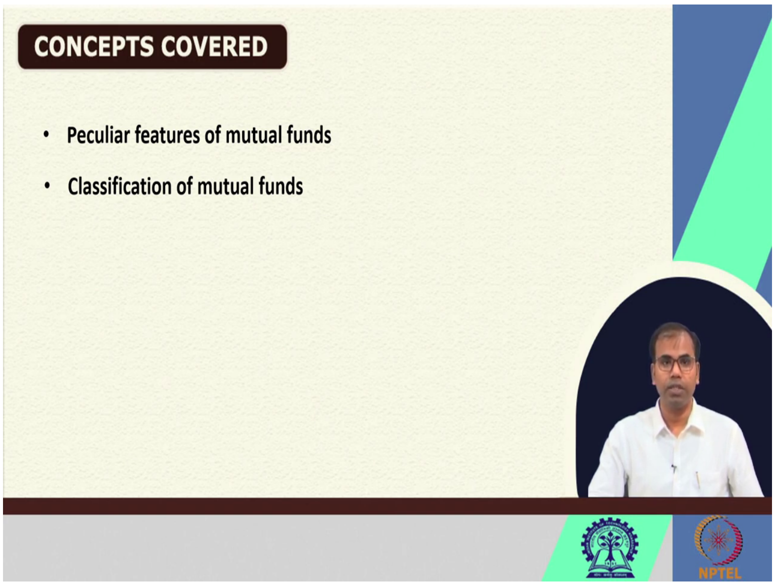

And particularly we will talk about peculiar features that might offer advantages or disadvantages at times for the investors who are looking out for investment in mutual funds. We will also try to understand classification of mutual funds based on different characteristics.

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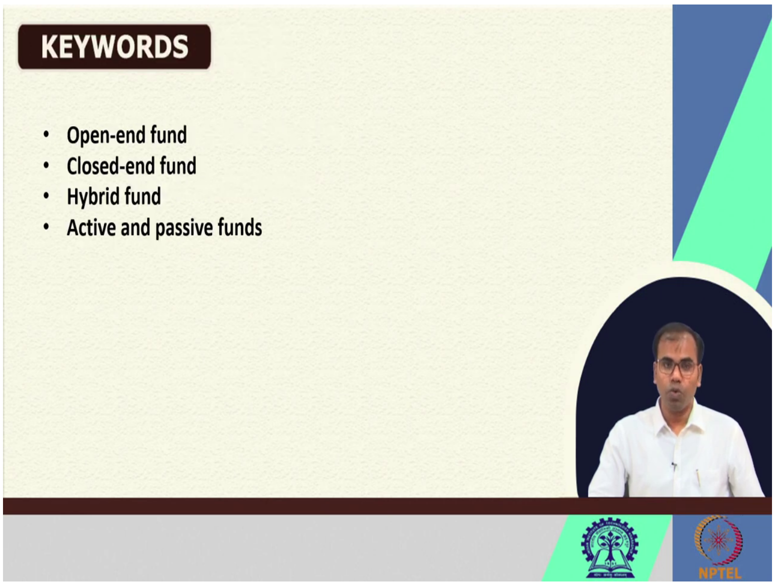

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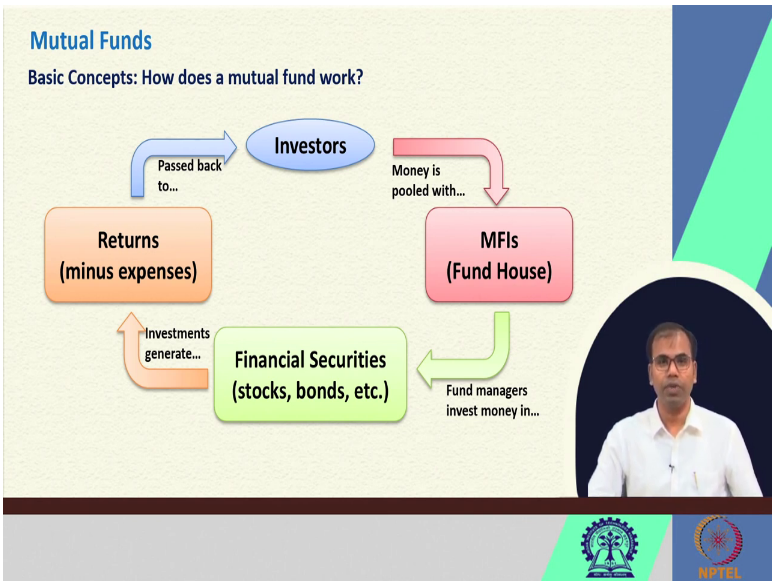

So, as we know mutual funds are basically instruments where investors come together to pool their money and the money is further invested in mutual funds or a mutual fund house manages the money via fund managers who invest the money into different financial instruments or financial securities such as stocks, bonds, etcetera.

And this investment subsequently generates return which will be partly used for taking care of the expenses and remaining is passed on to the investors. Now, if we try to understand the peculiar characteristics which can serve as an attraction or sometimes the advantage for investors particularly the retail or small investors or marginal investors.

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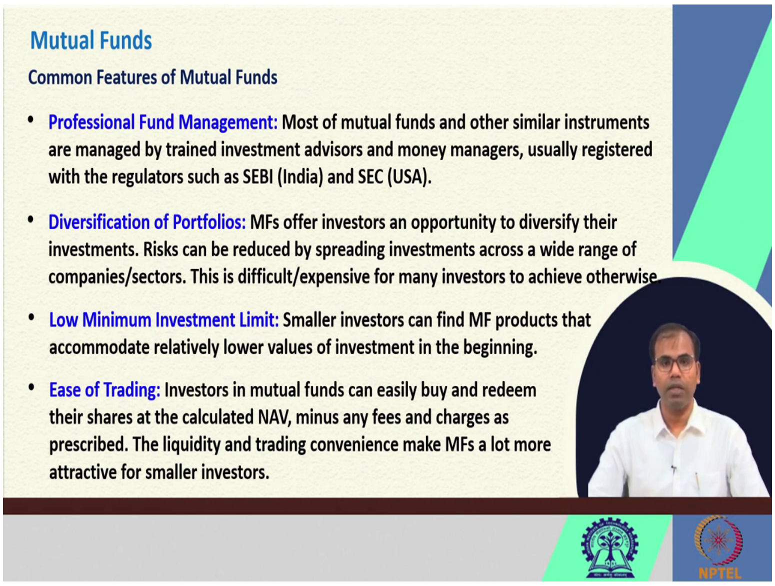

We know that there are certain features which can serve several benefits for retail or small investors. And first of the features is professional fund management. As we know most of the mutual funds and other fund based instruments are managed by trained investment advisors and money managers. Most of the time these money managers these fund managers are registered with the regulators such as SEBI which is Security Exchange Board of India or Security Exchange Commission in USA.

Now, advantage of having this kind of trained money managers is that we can rely on their skills most of the time and believe that they will be taking care of our money in a better way than we ourselves can do in general. Because not all investors might have the same set of skills, but they can keep their money they can leave the money with the trained professional money managers who are recognized by the regulators of the market and they can take care of the money management part.

Second advantage or second feature of the mutual funds is the diversification of portfolio. As we know that we should not keep all our eggs in a single basket we follow the same rule in case of a financial investments, which means all our money should not be going into similar type of assets. But as a retail investor as an individual investor, we cannot afford to do diversification at our end to large extent.

However, mutual fund offers such investors small investors and opportunity to diversify their investments where risk can be reduced by spreading investment across a wide range of companies or sometimes sectors depending on the investment objectives. Because otherwise this is a very difficult and expensive exercise for many retail investors who wants to achieve diversification.

For example, if a small investor wants to invest in 20 different sectors or 20 different stocks belonging to 5 different sectors, seek herself cannot do this exercise because maybe the amount of money that she has for investment is not sufficient to invest in those 20 stocks belonging to 5 different sectors.

However, such an investor can safely invest a small sum of money to a mutual fund which will eventually pool a pooling out a large sum of money from such several such small investors and use that money to invest in all those 20 stocks in a particular 5 sectors.

So, diversification of portfolio is rather easily achievable objective in case of mutual funds because individuals cannot do to that extent. However, when they several individuals are combined together in terms of their small funds then that can be achieved rather easily. Third objective is low minimum investment limit.

As we know typically small investors can find mutual fund products that accommodate relatively lower value of investment in the beginning which means an investor with a few hundred rupees can also start investing in mutual fund which is not possible in case of direct exposure or direct investment in equity markets.

Another feature or another advantage for investor is the ease of trading where investors in mutual funds can easily invest in or buy the shares or units of mutual fund at the same time they can also easily sell or redeem their shares at the calculated net asset value sends certain fees and charges as prescribed.

As we know that when a mutual fund is issued or mutual fund instrument is offered to an investor the charges such as transaction cost or management fee, research fee or brokerage charges these are pre-decided and communicated to the investors. So, whenever an individual investor or investor in mutual fund is trying to buy or redeem their shares at certain NAV, the total cost is deducted from the return or the income that in investor is expected to get.

But the convenience at which this exercise can be done cannot be possible in through investment directly in the equity market. So, the liquidity and trading convenience make mutual funds a lot more attractive for small investors with who cannot directly invest in equity market because of several constraints.

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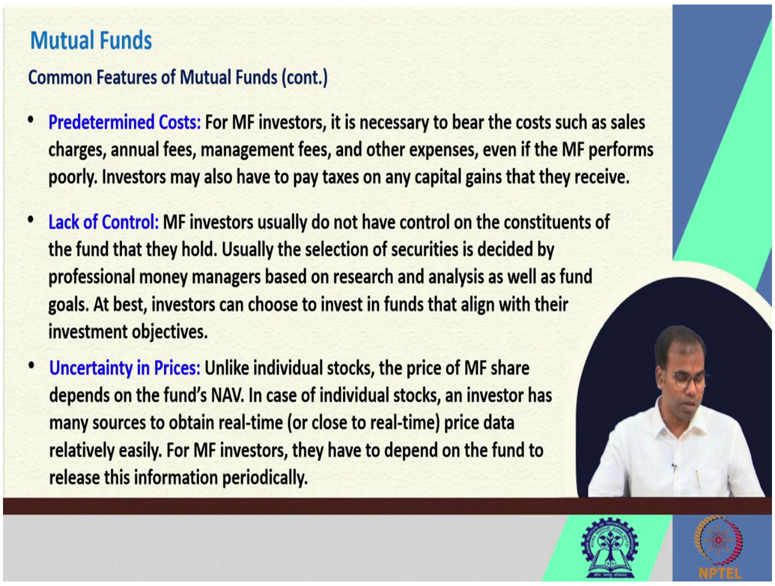

Other features or issues related to the mutual funds could be considered as the cost that are predetermined. We observe that for mutual fund managers the costs are basically decided in terms of their fees or any other transaction charges that can be incurred while managing the mutual funds.

So, for mutual fund investors it is necessary to bear the cost for example, sales charges, brokerage, annual fees, management fees, any other expenses even if the mutual fund is not performing well which means, if a mutual fund is not doing well in terms of profitability still the mutual fund investor has to bear the cost and investor have to pay taxes also on case in case of any capital gains that they receive.

So, these costs are predetermined and they cannot be avoided irrespective of the performance of the fund. Another issue related to mutual fund is the lack of control. So, as we know that mutual funds are typically managed by a professionally trained money manager not the original investors because original investors could be thousands and sometimes millions who would be pooling their money and that money is given that pooled money that pooled fund is given to the money manager who is taking the decision.

So, money mutual fund investors usually do not have any control on the constituents of the fund that they hold. Usually, the selection of securities particularly in case of mutual funds is decided by those trained professional money managers who do their own way of research and analysis before they take a decision about investing in a particular stock or a particular instrument based on the fund stated fund goals.

However, at best mutual fund investors can choose to invest in funds that align with their investment objective. For example, if I want to invest in instruments with an objective to invest for my retirement probably, I would try to find a mutual fund which will help me achieve that objective. So, even if an investor cannot have control or direct control over the choice of selection of securities, he or she can definitely find a mutual fund that will be the most closely aligned.

For example, if I want to invest in pharma sector stocks even though I cannot choose individual companies for my portfolio, I know that if I go for a pharma sector mutual fund or mutual fund with exposure to pharma sector companies then I can see that the mutual fund manager is selecting companies which belong to pharma sector and accordingly the portfolio is formulated.

So, even though I do not have direct control about the proportion of money going to different companies belonging to the pharmaceutical sectors in the portfolio. However, I can see that certain companies belonging to pharmaceutical sector are there in the portfolio and their weight is might be different from what I have thought, but still, I can find a fund which will align with my investment objective.

And finally, the uncertainty in prices of course, there should be risk or there might be risk which investors cannot avoid and unlike individual stocks the price of mutual fund shares depend on the net asset value of the fund.

In case of individual stocks as we know it an investor can always find real time or at least close to real time data about prices relatively easily from different sources and databases as simple as the website of the exchanges or sometimes other financial websites from where an investor can find real time or almost real time data about the prices of the instrument. However, in case of mutual funds that not very likely

For mutual fund investors they have to depend on the fund house or the fund managers to release this information about NAV periodically which will be released in the market in the public domain for the investors where the fund the investor in that fund will get to know about the price depend based on the funds in NAV. Even though with these issues such as predetermined cost irrespective of the performance of the fund, lack of control in the process of selecting securities for the fund and uncertainties in prices.

Mutual funds typically offer advantages that are far beyond the usual scenario where an individual is managing her own money compared to the scenario where individuals have pooled their money and given that fund to the professional money managers, the mutual fund typically surpasses the returns or outperform the individual investors in general.

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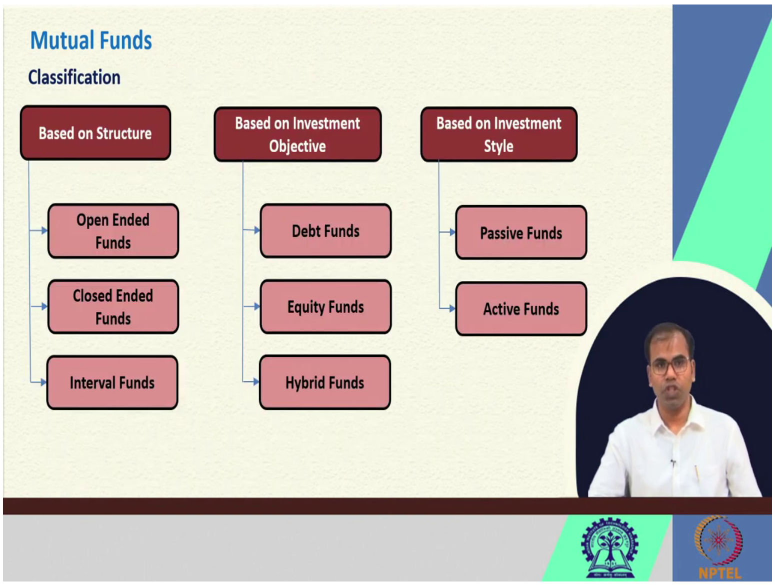

Having said this let us try to understand different types of classifications of mutual funds. So, we will try to classify or there are classifications based on three characteristics structure, investment objective and investment style. Based on structure we can categorize mutual funds into open-ended fund, closed-ended fund and interval funds or hybrid funds.

Based on investment objectives we can define mutual funds into debt funds, equity funds and hybrid funds. Similarly, based on investment style we can categorize mutual funds into passive and active fund.

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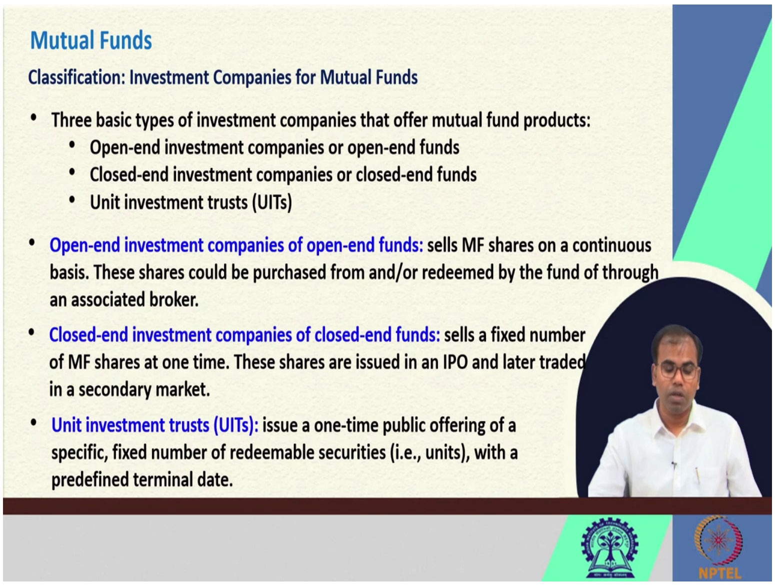

If you try to understand each of them in a more detailed way, we know that the first category is about the structure of the fund. So, based on the structure of the fund we can have three different types of mutual funds offering, open-ended, closed-ended and interval funds.

So, the open-ended funds are also known as open-ended investment companies are there which typically sells mutual fund shares on a continuous basis which means, every time all the time when you go to buy or sell, they keep on selling the mutual fund units or mutual fund shares. And these shares could be purchased from or sometime or as the case may be redeemed by the fund through fund house or associated broker.

So, typically these are like continuation continuous offering of a mutual fund house to the investors and anyone any investor can anytime walk in and buy a share or unit of a group of shares of this open-ended mutual fund or open-ended fund.

What happens in closed-ended funds or closed-end investment companies they sell a fixed number of mutual fund share at one time which means they release or they issues certain number of shares of a mutual fund or certain number of units of a mutual fund at one time through something called fund offering or very much similar to what we see in the case of Initial Public Offering or IPO.

And once these funds the these shares of a mutual fund are issued in the IPO process or in the fund offering process these funds these shares are later on traded in secondary market. So, if you look at the NFO data which is basically New Fund Offering data it tells us about the number of closed-ended funds being offered to the public for investment in open market.

And typically, they issue select certain number of shares only at one time and those shares are available for trading later on after the issuance to the public. And finally, the Unit Investment Trust UIT which issue or one time public offering of a specific fixed number of redeemable shares or securities also known as unit with a pre-defined terminal date which means, unit investment trust will be financial instruments which are issued to the public in one time for a specific number of redeemable securities.

And they always have a maturity date or a terminal date after which this contract the financial instrument sell sees. Now, these are three broad categories based on the structure of mutual funds.

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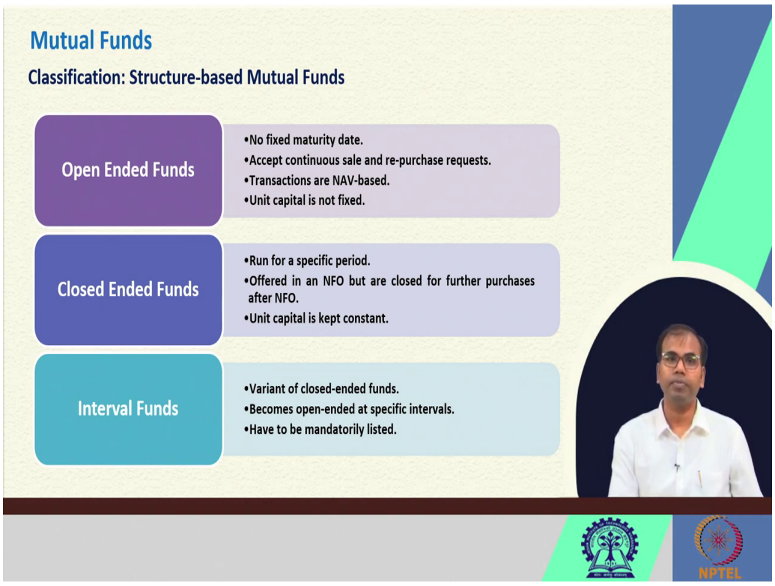

If you look at other characteristics such as the fund which are based on investment objective or investment style will look into their characteristics also. So, just before that we already see that open-ended funds closed-ended funds are there where open-ended fund do not have any maturity date all the time it is being sold to the investors, they accept continuous sale of or repurchase requests.

There are their transactions are based on the net asset value and a unit capital is not fixed for such funds. For closed-ended funds they run for a very specific period in the form of New Fund Offering or NFO which is very much similar to what we know as IPO and they are closed for further purchases after NFO is completed. And unit capital is kept consistent.

In case of interval funds, we know that variant of closed-ended funds are similar to interval funds. It becomes open-ended at specific intervals which means during those intervals though the buying and selling of these shares of mutual fund can be done and they have to be mandatorily listed in the stock exchange or the market exchange.

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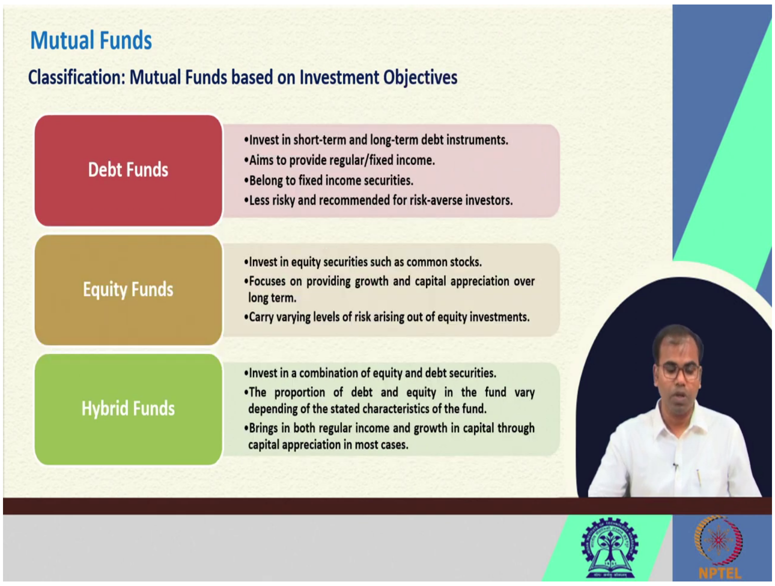

If you look at the investment objective and classification of mutual fund: based on that there are three broad categories debt funds, equity funds and hybrid funds. Debt funds are those instruments that invest in short-term or long-term debt instruments which means, they invest in fixed-income securities they belong to the fixed-income securities category.

Debt fund aim to provide regular or fixed-income for the investors. So, if I am an investor who is seeking a fixed-income through my investment I would prefer to invest my money in debt fund because also it is less risky and it is recommended for risk-averse investors who do not want to assume larger risk.

On the other side there are equity funds that invest in equity securities such as common stocks of different companies. They focus on providing growth and capital appreciation over long-term, but at the same time they also carry varying levels of risk arising out of equity investment which means, equity funds are very much similar to equity albeit in a different way or in a group way.

And then comes the hybrid funds that invest in a combination of equity and debt securities which is basically hybrid of equity and debt instruments. The proportion of debt and equity in the fund may vary depending on the stated objective or characteristics of the fund. However, it brings in both regular income and capital appreciation or growth in capital through capital appreciation in most cases.

And at the same time, it will also have higher level of risk compared to debt instrument fund, but might have lower level of risk compared to pure equity funds. So, basically hybrid funds are a combination of debt and equity funds where some money some investible fund will go into debt instrument and some other money will go into equity instrument thereby trying to make a balance between less risky assets and more risky assets.

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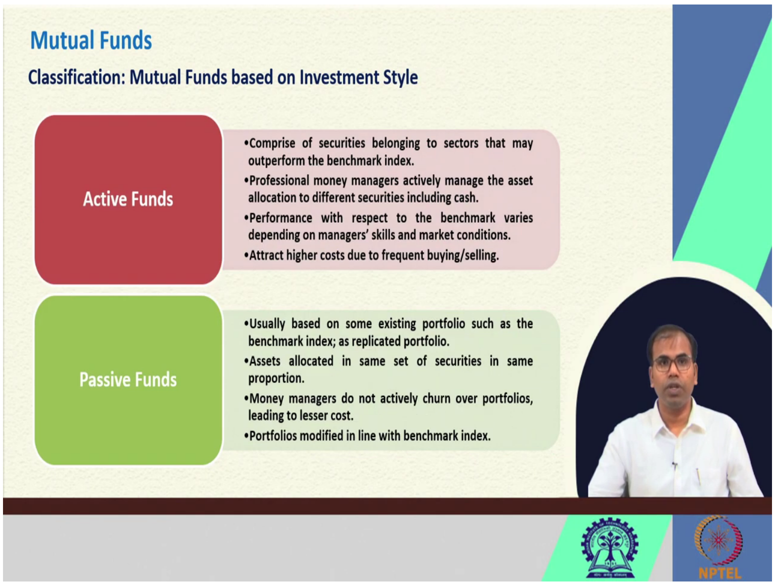

Another classification of mutual fund is based on the activities or investment style. As we have seen there are active mutual funds or passive mutual funds or actively managed mutual funds and passively managed mutual funds. If you look at the characteristics of actively managed mutual funds or active funds, we know that active funds comprise of securities that belong to different sectors and are expected to outperform the benchmark index.

The job of the professional money managers is to actively engaged in the portfolio Churn over or asset allocation across different securities including cash which means, professionally trained money managers are required to look out for investment opportunities. Turn around the portfolio selling new selling the existing shares, existing investment and bringing in new investment or investing the money in new stocks or new instruments.

These are being taken being carried out continuously and that is why it is called active funds or actively managed funds. The performance of such funds with respect to the benchmark such as NIFTY, SENSEX or NASDAQ varies depending on managers skill and market conditions.

Because as we know this these the managers are required to be actively managing the funds, they do not depend on how the market is moving rather it depends on how skillful they are in terms of money management or identifying the worst performers or expected winners for inclusion in the portfolio.

As we can understand since professionally trained money managers are actively managing the funds. So, they might attract higher cost due to frequent buying and selling and that is how the cost of managing or cost of investing in these actively managed or active funds is also high.

In case of passive funds, the scenario is opposite which means; typically, passive funds are based on served some existing portfolios more preferably the benchmark index and actively passively managed funds are basically the replicated portfolio. Assets are allocated in term in the same set of securities in the same proportion to replicate the portfolio or replicate the benchmark.

For example, if I form a portfolio of assets exactly as a replica of let us say NIFTY 50 index what I mean is if there are 50 stocks included in NIFTY 50 index in certain proportion my portfolio will be replicated exactly in the same proportion across the same set of stocks that are included in NIFTY 50.

So, I do not have to do any active fund management I will just in the very beginning allocate the assets in the same proportion across the same set of securities that are included in NIFTY 50 and I can sit and relax and that is why it is called passively managed funds.

So, if NIFTY goes up the stocks or the value of the stocks included in my portfolio will also go up and vice versa which means is money managers do not actively churn or out the portfolios and that is why they do not incur lot of cost as well. So, from cost point of view passive funds are cheaper than the active funds because of the obvious reasons and portfolio can be modified in line with the benchmark index.

For example, in some time in future if NIFTY 50 index drops a particular company, then I will also have to drop that particular company from my portfolio that is a replica of NIFTY 50 or any other index benchmark index. So, these are a classification of funds based on investment style.

So, we have seen the structure of the fund defines funds to be within closed ended funds, open ended funds and interval or unit investment trust. Based on the investment objective we can have a portfolios or funds which can have investment in debt instrument equity instrument and hybrid instrument and then we have actively managed funds or and passively managed funds based on the investment style.

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If we want to see the takeaway of the discussion about the advantages and disadvantages along with the categorization of mutual fund or classification of mutual fund. We know that in the market out there or we are self as an investor are always seeking indirect investment opportunities.

Where we can minimize the risk and do not want to put much effort in terms of selection of securities or asset allocation exercise. And for that mutual funds typically offer the best solution. So, the takeaway is mutual funds can be classified or categorized based on different characteristics such as structure, investment style, investment objective.

For example, if I want to have money after 20 years or only for my retirement, then I will try to find a fund which will invest in securities which will generate possibly higher than average return in long run. So, I would rather put my money in that mutual fund and sit back and relax for next 20 years the fund manager will take care of the asset allocation and other job.

So, for investor it is recommended to identify different schemes based on the composition or characteristics of the portfolio or the fund we can have equity schemes where investment is made into equity securities. Then we have debt schemes where investment by money managers is done in debt instrument or fixed income securities.

Then we have hybrid schemes where investment is made into both equity and debt scheme in certain proportion depending on the preference for risk and return. Then we have solution oriented schemes for example, there are funds which will guarantee you certain amount of fund after certain period of time for achieving certain goals. For example, let us say child education fund or house building fund and so on retirement fund the previous example.

And then there are other schemes which will have peculiar characteristics like funds which will follow certain religious practices funds which will have something like Green Technology the companies which are adopting Green Technology or sustainable production methods or sustainable technologies. The fund which invest in such companies might also be might also attract investors which will have references for such companies.

So, for example, if I want my money to go into only those companies which have sustainable and green practices which does not cause much harm to the environment, then I would rather try to find a fund which will locate the assets into such companies only. So, those are other type of schemes or mutual funds available for investors.

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With this I think I can conclude saying that mutual funds as an investment tool offer investors several features such as the professionally professional money management skills, portfolio diversification, lower cost and sometimes tax advantage also. These features are otherwise not easy to achieve for individual or retail investors.

Funds are usually characterized based on their structure such as open ended fund, closed ended fund or unit investment trust. They can also be characterized based on investment objectives such as a debt fund or equity fund or hybrid fund and sometimes they are also characterized as in and the basis of their investment style. For example, actively managed fund or passively managed fund or solution oriented funds and so on. With this I conclude this session. Look forward to seeing you in next session.

Thank you very much.

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