Mr Rajesh recently closed a deal for his company which resulted in annual savings of Rs.3.5 Crores. Company rewarded him with a generous bonus of Rs.10 Lakhs. Mr Rajesh thought that this may be the right opportunity to invest for his 8 year old daughter's college education needs. His financial advisor suggested that he can investment Rs.7 Lakhs in a diversified mutual fund and the rest in a debt fund. Rajesh had little knowledge about 'diversified mutual fund' and 'debt fund' and requested his financial advisor to explain further.

Ms Radhika is a software engineer and received her first pay cheque last month. Radhika's father advised her to save regularly for future. When she discussed with her financial advisor, he advised Janaki to start an SIP. So what is an SIP?

M/s First Class Developers are a medium sized real estate developers and have launched a 300 Crores project recently. Every week, they would receive approximately Rs.15 Crores from the buyers. They will start their project work only after six months. In the meantime, Chief Financial Officer of First Class Developers wants to park the cash flow in a safe place. He would also like to access the money quickly in case of a need. Company's investment advisor suggested that the money may be parked in a liquid fund. What's this 'liquid fund'?

In the above three cases, financial advisors were referring to different types of mutual funds. As you would have noticed correctly, mutual funds are sought by many types of investors under such varied situations. So, what is a mutual fund?

## Mutual Fund

A mutual fund is a trust that aggregates the savings and investments from a number of persons who have a common investment objective. Then mutual fund moves on to invest the pool of money in to various financial instruments such as stocks, debentures and certificates of deposits and manages these investments. The income and gains as well as losses are shared by all the investors in proportion to the money they have invested.

There are a number of stakeholders involved in the process of running a mutual fund.

## Regulator

Mutual funds collect money from the public and they need to follow several rules and regulations. Securities Exchange Board of India (SEBI) is the prime regulator of mutual fund industry in India. SEBI, established in 1992 in accordance with Securities and Exchange Board of India Act, 1992, has the mandate to protect the interests of investors in securities and to promote the development of, and to regulate the securities market. SEBI provides the regulatory framework and oversees the functioning of mutual fund industry in order to ensure the protection of public interest.

After the regulator, let's look at the structure of fund itself. 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 who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the investors in the fund. The trustees have the oversight on the AMC and give it the direction to meet the fund objectives. They monitor the performance and compliance of SEBI Regulations by the mutual fund. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various approved securities and financial instruments. Custodian, who is registered with SEBI, holds the investments of the fund in its custody.

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. All mutual funds are required to be registered with SEBI before they launch any scheme.

## Classification of Funds

There are 47 mutual funds or fund houses in the last count as on Sep 2009 and several hundred schemes floated by these funds. Mutual funds cater to the investment needs of almost all categories of investors; be it individual investor with a small amount to invest or a high net worth individual, be it a small business or a big industry house, everyone can find a product to meet their requirements. Such is the breadth and depth of mutual funds and the schemes in India.

Listed below are some of the popular classifications of mutual funds:

### Maturity based classification

- Open ended schemes
- Close ended schemes
- Interval schemes
- Fixed Maturity Plans

### Fee based classification

- Load funds
- No load funds

### Objective based classification

- Income funds
- Growth funds
- Income and growth funds

### Asset based classification

- Equity funds

- Debt Funds
- Balanced Funds
- Index Funds

## Other classifications

### Sector/Thematic Funds

- Pharmaceutical sector funds
- Banking sector funds
- Infrastructure funds
- Natural Resources Fund
- International Fund

### Special Funds

- Equity Linked Saving Schemes (Tax Planning Funds)
- Children Education funds
- Fund of Funds
- Exchange Traded Funds
- Structured funds

## Self Regulatory Organisation (SRO) in mutual fund industry

Association of Mutual Funds in India (AMFI) is a Self Regulatory Organisation promoted by mutual funds in India. AMFI has following activities as its objectives:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
- To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the Mutual Fund Industry.
- To develop a cadre of well trained Agent distributors and to implement a programme of training and certification for all intermediaries and other engaged in the industry.
- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on Mutual Fund Industry and to undertake studies and research directly and/or in association with other bodies.

AMFI is the nodal organisation responsible for training and certification of the intermediaries for mutual fund industry.

## Advantages of mutual fund

Investing in mutual funds is growing in popularity with the investing public day by day. Following are some of the attributes for the growing popularity of mutual funds

- Professional Management
- Diversification
- Convenient Administration
- Return Potential
- Low Costs
- Liquidity
- Transparency
- Flexibility
- Choice of Schemes
- Well Regulated

## How to investment in a mutual fund?

Once the investor decides his investment needs, he may invest in mutual funds in two ways:

- Investing in existing funds
- Investing in new fund offers

Open-ended schemes would available for investment on any working day from the fund house. Exchange traded funds also would be available for investment.

An investor can invest in a fund either directly from a fund house or through an intermediary. Mutual fund intermediary is also known as mutual fund broker. One can invest in many funds through a mutual fund broker. If the investor chooses to invest directly, he has to approach the fund houses himself.

New funds are offered by the fund house and will be open for subscription, similar to an initial public offer of a share. But these two are not the same. New funds, after initial period, may be instituted as open ended or close ended funds.

Who are eligible to invest in mutual funds?

Following persons/entities are eligible to invest in mutual funds in India:

- Resident Individuals, including minors and housewives
- Hindu Undivided Families

- Partnership firms
- Companies, Bodies Corporate, Public Sector Undertakings, Association of Persons or bodies of individuals and societies registered under the Societies Registration Act, 1860;
- Religious and Charitable trusts
- Nonresident Indian (NRI)/Person of Indian Origin (PIO)
- Foreign Institutional Investors
- Provident Funds, Pension Funds, Superannuation Funds

(Note: above list is partial and subject to change. For full list, refer offer document of a mutual fund)

## Role of intermediaries in the mutual fund industry

Intermediaries play two important roles in the process of mutual fund investment. First, advising investor in selecting the funds and actually executing the investment by completing the required paperwork. Second, an intermediary would guide the investor through other phases of investment such as additional purchases, switching, rebalancing, repurchase (redemption) and keeping the personal information and bank details update. An intermediary would also keep the investor updated on the performance of the fund and comparison of various funds.

## Documents required for investing in a mutual fund

An investor who wishes to invest in a mutual fund should possess Permanent Account Number (PAN) allotted by Income Tax Department. If an investor wishes to invest Rs.50000/- or more at a time, he should additional complete Know Your Client (KYC) requirements. KYC needs an investor to provide identity and address proofs along with PAN to central record keeping institution and get KYC registration done.

In addition to the above requirements, mutual fund investment can be done only if the investor holds a bank account. He can invest through a cheque or demand draft and cash is not acceptable.

## What an investor should know before investing in a mutual fund?

Investor must go through the offer document before investing in a mutual fund. Offer document provides an investor with information such as objective of the fund and risk factors. Offer document would also provide information on sponsor, AMC, trustee and custodian.

All investments carry several risks. Investing in a mutual fund also is not an exception to this rule. The risk factors that affect the underlying assets of a fund also affect the performance of a mutual fund.

An investor must first identify his needs by asking questions such as

- What are his investment needs and objectives?
- How much risk he is willing to take?
- When his investments should generate cash flows?

Once investor answers these questions, he can select the fund or funds that meet his needs. An ideal mix of asset classes should be selected in order to diversify the risks. An intermediary, who is specially trained, can guide the investor in this process.

Although mutual funds provide a superior framework for an investor, he should be well aware of the factors such as entry and exit loads, management expense and other costs and fees.

## Some key words explained

### *Asset Allocation*

A term used to describe an investor's approach for dividing the portfolio into stocks, bonds and cash and their sub-categories. This strategy is designed to minimise the danger of putting all eggs in one basket.

### *Asset management fee*

The fee charged by the asset management company (AMC) for portfolio management. The fee charged on an annual basis is calculated as percentage of net assets under management.

### *Balanced fund*

A portfolio of stocks and bonds in varying proportions.

### *Closed-end fund*

Closed-end funds neither issue fresh units to investors nor repurchase them. Some closed-ended funds are listed in the stock exchange and can be bought and sold like any other stock. Otherwise, investors have to wait till the redemption date to exit from the fund.

### *Custodian*

The independent organization that is responsible for the handling and safekeeping of a fund's cash and securities.

### *Distributor*

A form of mutual fund broker that supplies mutual fund products to investors.

### *Exit load*

A sales charge paid when an investor sells a fund; also known as Back-end load. With effect from 1.8.2009, SEBI has abolished entry load on all mutual funds in India. For more details, click here.

### *Entry load*

A sales fee charged at the time of purchase of mutual fund units; also known as Front-end load.

### *Expense ratio*

The annual expenses of a fund including the management fee, administrative costs, divided by the number of units on that day.

### *Net asset value (NAV)*

The price or value of one unit of a fund. It is calculated by summing the current market values of all securities held by the fund, adding in cash and any accrued income, then subtracting liabilities and dividing the result by the number of units outstanding.

### *No-load fund*

A fund with no entry or exit load.

### *Repurchase Price*

Is the price at which units under open-ended schemes are repurchased by the Mutual Fund. It may include an exit load.

### *Redemption Price*

Is the price at which close-ended schemes redeem their units on maturity.

### *Sale Price*

Is the price investor pays when he invest in a mutual fund scheme. Also called Offer Price. It may include an entry load.

### *Systematic Investment Plan (SIP)*

An investment technique enabled by the mutual funds where an investor buys units of a mutual fund on a fixed date for a fixed sum. Idea behind SIP is to average the cost of acquisition (Rupee Cost Averaging) of units.

*Unit*

When money is invested in mutual funds 'units' are allotted to the investor. Units are arrived at by dividing the investment amount by net asset value (NAV) per unit. This is subject to adjustment for entry load. Face of value of the unit is Rs.10/-

**Disclaimer:** This article does not purport to neither be an advice nor a complete guide on mutual fund or investing in mutual fund. Investor must consult a licenced professional on his investment decisions before investing.