What is a Mutual Fund?

Mutual fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document.

Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders.

The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. A mutual fund is required to be registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public.

What is the history of Mutual Funds in India and role of SEBI in mutual funds industry?

Unit Trust of India was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up mutual funds.

In the year 1992, Securities and exchange Board of India (SEBI) Act was passed. The objectives of SEBI are – to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

As far as mutual funds are concerned, SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

How is a mutual fund 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 promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unitholders. 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 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. All mutual funds are required to be registered with SEBI before they launch any scheme.

What is Net Asset Value (NAV) of a scheme?

The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV).

Mutual funds invest the money collected from the investors in securities markets. In simple words, Net Asset Value is the market value of the securities held by the scheme. Since market value of securities changes every day, NAV of a scheme also varies on day to day basis. The NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on any particular date. For example, if the market value of securities of a mutual fund scheme is Rs 200 lakhs and the mutual fund has issued 10 lakhs units of Rs. 10 each to the investors, then the NAV per unit of the fund is Rs.20. NAV is required to be disclosed by the mutual funds on a regular basis - daily or weekly - depending on the type of scheme.

What are the different types of mutual fund schemes?

Schemes according to Maturity Period:

A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period.

Open-ended Fund/ Scheme

An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.

Close-ended Fund/ Scheme

A close-ended fund or scheme has a stipulated maturity period e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

Schemes according to Investment Objective:

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

Growth / Equity Oriented Scheme

The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

Income / Debt Oriented Scheme

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, Government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations.

Balanced Fund

The aim of balanced funds is to provide both growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These are appropriate for investors looking for moderate growth. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

Money Market or Liquid Fund

These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods

Gilt Fund

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

Index Funds

Index Funds replicate the portfolio of a particular index such as the BSE Sensitive index, S&P NSE 50 index (Nifty), etc These schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as "tracking error" in technical terms. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme. There are also exchange traded index funds launched by the mutual funds which are traded on the stock exchanges.

What are sector specific funds/schemes?

These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time. They may also seek advice of an expert.

What are Tax Saving Schemes?

These schemes offer tax rebates to the investors under specific provisions of the Income Tax Act, 1961 as the Government offers tax incentives for investment in specified avenues. e.g. Equity Linked Savings Schemes (ELSS). Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

What is a Fund of Funds (FoF) scheme?

A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a FoF scheme. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe

What is a Load or no-load Fund?

A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase to the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the performance track record and service standards of the mutual fund which are more important. Efficient funds may give higher returns in spite of loads.

A no-load fund is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and no additional charges are payable on purchase or sale of units.

Can a mutual fund impose fresh load or increase the load beyond the level mentioned in the offer documents?

Mutual funds cannot increase the load beyond the level mentioned in the offer document. Any change in the load will be applicable only to prospective investments and not to the original investments. In case of imposition of fresh loads or increase in existing loads, the mutual funds are required to amend their offer documents so that the new investors are aware of loads at the time of investments.

What is a sales or repurchase/redemption price?

The price or NAV a unitholder is charged while investing in an open-ended scheme is called sales price. It may include sales load, if applicable.

Repurchase or redemption price is the price or NAV at which an openended scheme purchases or redeems its units from the unitholders. It may include exit load, if applicable.

What is an assured return scheme?

Assured return schemes are those schemes that assure a specific return to the unitholders irrespective of performance of the scheme.

A scheme cannot promise returns unless such returns are fully guaranteed by the sponsor or AMC and this is required to be disclosed in the offer document.

Investors should carefully read the offer document whether return is assured for the entire period of the scheme or only for a certain period. Some schemes assure returns one year at a time and they review and change it at the beginning of the next year.

Can a mutual fund change the asset allocation while deploying funds of investors?

Considering the market trends, any prudent fund managers can change the asset allocation i.e. he can invest higher or lower percentage of the fund in equity or debt instruments compared to what is disclosed in the offer document. It can be done on a short term basis on defensive considerations i.e. to protect the NAV. Hence the fund managers are allowed certain flexibility in altering the asset allocation considering the interest of the investors. In case the mutual fund wants to change the asset allocation on a permanent basis, they are required to inform the unitholders and giving them option to exit the scheme at prevailing NAV without any load.

How to invest in a scheme of a mutual fund?

Mutual funds normally come out with an advertisement in newspapers publishing the date of launch of the new schemes. Investors can also contact the agents and distributors of mutual funds who are spread all over the country for necessary information and application forms. Forms can be deposited with mutual funds through the agents and distributors who provide such services. Nowadays, the post offices and banks also distribute the units of mutual funds. However, the investors may please note that the mutual funds schemes being marketed by banks and post offices should not be taken as their own schemes and no assurance of returns is given by them. The only role of banks and post offices is to help in distribution of mutual funds schemes to the investors.

Investors should not be carried away by commission/gifts given by agents/distributors for investing in a particular scheme. On the other hand they must consider the track record of the mutual fund and should take objective decisions.

Can non-resident Indians (NRIs) invest in mutual funds?

Yes, non-resident Indians can also invest in mutual funds. Necessary details in this respect are given in the offer documents of the schemes.

How much should one invest in debt or equity oriented schemes?

An investor should take into account his risk taking capacity, age factor, financial position, etc. As already mentioned, the schemes invest in different type of securities as disclosed in the offer documents and offer different returns and risks. Investors may also consult financial experts before taking decisions. Agents and distributors may also help in this regard.

How to fill up the application form of a mutual fund scheme?

An investor must mention clearly his name, address, number of units applied for and such other information as required in the application form. He must give his bank account number so as to avoid any fraudulent encashment of any cheque/draft issued by the mutual fund at a later date for the purpose of dividend or repurchase. Any changes in the address, bank account number, etc at a later date should be informed to the mutual fund immediately.

What should an investor look into an offer document?

An abridged offer document, which contains very useful information, is required to be given to the prospective investor by the mutual fund. The application form for subscription to a scheme is an integral part of the offer document. SEBI has prescribed minimum disclosures in the offer document. An investor, before investing in a scheme, should carefully read the offer document. Due care must be given to portions relating to main features of the scheme, risk factors, initial issue expenses and recurring expenses to be charged to the scheme, entry or exit loads, sponsor's track record, educational qualification and work experience of key personnel including fund managers, performance of other schemes launched by the mutual fund in the past, pending litigations and penalties imposed, etc

When will the investor get certificate or statement of account after investing in a mutual fund?

Mutual funds are required to dispatch certificates or statements of accounts within six weeks from the date of closure of the initial subscription of the scheme. In case of close-ended schemes, the investors would get either a demat account statement or unit certificates as these are traded in the stock exchanges. In case of open-ended schemes, a statement of account is issued by the mutual fund within 30 days from the date of closure of initial public offer of the scheme. The procedure of repurchase is mentioned in the offer document.

How long will it take for transfer of units after purchase from stock markets in case of close-ended schemes?

According to SEBI Regulations, transfer of units is required to be done within thirty days from the date of lodgment of certificates with the mutual fund.

As a unitholder, how much time will it take to receive dividends/repurchase proceeds?

A mutual fund is required to despatch to the unitholders the dividend warrants within 30 days of the declaration of the dividend and the redemption or repurchase proceeds within 10 working days from the date of redemption or repurchase request made by the unitholder.

In case of failures to despatch the redemption/repurchase proceeds within the stipulated time period, Asset Management Company is liable to pay interest as specified by SEBI from time to time (15% at present).

Can a mutual fund change the nature of the scheme from the one specified in the offer document?

Yes. However, no change in the nature or terms of the scheme, known as fundamental attributes of the scheme e.g. structure, investment pattern, etc. can be carried out unless a written communication is sent to each unitholder and an advertisement is given in one English daily having nationwide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated. The unitholders have the right to exit the scheme at the prevailing NAV without any exit load if they do not want to continue with the scheme. The mutual funds are also required to follow similar procedure while converting the scheme form close-ended to open-ended scheme and in case of change in sponsor.

How will an investor come to know about the changes, if any, which may occur in the mutual fund?

There may be changes from time to time in a mutual fund. The mutual funds are required to inform any material changes to their unitholders. Apart from it, many mutual funds send quarterly newsletters to their investors.

At present, offer documents are required to be revised and updated at least once in two years. In the meantime, new investors are informed about the material changes by way of addendum to the offer document till the time offer document is revised and reprinted.

How to know the performance of a mutual fund scheme?

The performance of a scheme is reflected in its net asset value (NAV) which is disclosed on daily basis in case of open-ended schemes and on weekly basis in case of close-ended schemes. The NAVs of mutual funds are required to be published in newspapers. The NAVs are also available on the web sites of mutual funds. All mutual funds are also required to put their NAVs on the web site of Association of Mutual Funds in India (AMFI) www.amfiindia.com and thus the investors can access NAVs of all mutual funds at one place.

The mutual funds are also required to publish their performance in the form of half-yearly results which also include their returns/yields over a period of time i.e. last six months, 1 year, 3 years, 5 years and since inception of schemes. Investors can also look into other details like percentage of expenses of total assets as these have an affect on the yield and other useful information in the same half-yearly format.

The mutual funds are also required to send annual report or abridged annual report to the unitholders at the end of the year.

Various studies on mutual fund schemes including yields of different schemes are being published by the financial newspapers on a weekly basis. Apart from these, many research agencies also publish research reports on performance of mutual funds including the ranking of various schemes in terms of their performance. Investors should study these reports and keep themselves informed about the performance of various schemes of different mutual funds.

Investors can compare the performance of their schemes with those of other mutual funds under the same category. They can also compare the performance of equity oriented schemes with the benchmarks like BSE Sensitive Index, S&P CNX Nifty, etc.

On the basis of performance of the mutual funds, the investors should decide when to enter or exit from a mutual fund scheme.

How to know where the mutual fund scheme has invested money mobilised from the investors?

The mutual funds are required to disclose full portfolios of all of their schemes on half-yearly basis which are published in the newspapers. Some mutual funds send the portfolios to their unitholders.

The scheme portfolio shows investment made in each security i.e. equity, debentures, money market instruments, government securities, etc. and their quantity, market value and % to NAV. These portfolio statements also required to disclose illiquid securities in the portfolio, investment made in rated and unrated debt securities, non-performing assets (NPAs), etc.

Some of the mutual funds send newsletters to the unitholders on quarterly basis which also contain portfolios of the schemes.

Is there any difference between investing in a mutual fund and in an initial public offering (IPO) of a company?

Yes, there is a difference. IPOs of companies may open at lower or higher price than the issue price depending on market sentiment and perception of investors. However, in the case of mutual funds, the par value of the units may not rise or fall immediately after allotment. A mutual fund scheme takes some time to make investment in securities. NAV of the scheme depends on the value of securities in which the funds have been deployed.

If schemes in the same category of different mutual funds are available, should one choose a scheme with lower NAV?

Some of the investors have the tendency to prefer a scheme that is available at lower NAV compared to the one available at higher NAV. Sometimes, they prefer a new scheme which is issuing units at Rs. 10 whereas the existing schemes in the same category are available at much higher NAVs. Investors may please note that in case of mutual funds schemes, lower or higher NAVs of similar type schemes of different mutual funds have no relevance. On the other hand, investors should choose a scheme based on its merit considering performance track record of the mutual fund, service standards, professional management, etc. This is explained in an example given below.

Suppose scheme A is available at a NAV of Rs.15 and another scheme B at Rs.90. Both schemes are diversified equity oriented schemes. Investor has put Rs. 9,000 in each of the two schemes. He would get 600 units (9000/15) in scheme A and 100 units (9000/90) in scheme B. Assuming that the markets go up by 10 per cent and both the schemes perform equally good and it is reflected in their NAVs. NAV of scheme A would go up to Rs. 16.50 and that of scheme B to Rs. 99. Thus, the market value of investments would be Rs. 9,900 (600* 16.50) in scheme A and it would be the same amount of Rs. 9900 in scheme B (100*99). The investor would get the same return of 10% on his investment in each of the schemes. Thus, lower or higher NAV of the schemes and allotment of higher or lower number of units within the amount an investor is willing to invest, should not be the factors for making investment decision. Likewise, if a new equity oriented scheme is being offered at Rs.10 and an existing scheme is available for Rs. 90, should not be a factor for decision making by the investor. Similar is the case with income or debt-oriented schemes.

On the other hand, it is likely that the better managed scheme with higher NAV may give higher returns compared to a scheme which is available at lower NAV but is not managed efficiently. Similar is the case of fall in NAVs. Efficiently managed scheme at higher NAV may not fall as much as inefficiently managed scheme with lower NAV. Therefore, the investor should give more weightage to the professional management of a scheme instead of lower NAV of any scheme. He may get much higher number of units at lower NAV, but the scheme may not give higher returns if it is not managed efficiently.

How to choose a scheme for investment from a number of schemes available?

As already mentioned, the investors must read the offer document of the mutual fund scheme very carefully. They may also look into the past track record of performance of the scheme or other schemes of the same mutual fund. They may also compare the performance with other schemes having similar investment objectives. Though past performance of a scheme is not an indicator of its future performance and good performance in the past may or may not be sustained in the future, this is one of the important factors for making investment decision. In case of debt oriented schemes, apart from looking into past returns, the investors should also see the quality of debt instruments which is reflected in their rating. A scheme with lower rate of return but having investments in better rated instruments may be safer. Similarly, in equities schemes also, investors may look for quality of portfolio. They may also seek advice of experts.

Are the companies having names like mutual benefit the same as mutual funds schemes?

Investors should not assume some companies having the name "mutual benefit" as mutual funds. These companies do not come under the purview of SEBI. On the other hand, mutual funds can mobilise funds from the investors by launching schemes only after getting registered with SEBI as mutual funds.

Is the higher net worth of the sponsor a guarantee for better returns?

In the offer document of any mutual fund scheme, financial performance including the net worth of the sponsor for a period of three years is required to be given. The only purpose is that the investors should know the track record of the company which has sponsored the mutual fund. However, higher net worth of the sponsor does not mean that the scheme would give better returns or the sponsor would compensate in case the NAV falls.

Where can an investor look out for information on mutual funds?

Almost all the mutual funds have their own web sites. Investors can also access the NAVs, half-yearly results and portfolios of all mutual funds at the web site of Association of mutual funds in India (AMFI) www.amfiindia.com. AMFI has also published useful literature for the investors.

Investors can log on to the web site of SEBI www.sebi.gov.in and go to "Mutual Funds" section for information on SEBI regulations and guidelines, data on mutual funds, draft offer documents filed by mutual funds, addresses of mutual funds, etc. Also, in the annual reports of SEBI available on the web site, a lot of information on mutual funds is given.

There are a number of other web sites which give a lot of information of various schemes of mutual funds including yields over a period of time. Many newspapers also publish useful information on mutual funds on daily and weekly basis. Investors may approach their agents and distributors to guide them in this regard.

Can an investor appoint a nominee for his investment in units of a mutual fund?

Yes. The nomination can be made by individuals applying for / holding units on their own behalf singly or jointly. Non-individuals including society, trust, body corporate, partnership firm, Karta of Hindu Undivided Family, holder of Power of Attorney cannot nominate.

If mutual fund scheme is wound up, what happens to money invested?

In case of winding up of a scheme, the mutual funds pay a sum based on prevailing NAV after adjustment of expenses. Unitholders are entitled to receive a report on winding up from the mutual funds which gives all necessary details.

How can the investors redress their complaints?

Investors would find the name of contact person in the offer document of the mutual fund scheme whom they may approach in case of any query, complaints or grievances. Trustees of a mutual fund monitor the activities of the mutual fund. The names of the directors of asset management company and trustees are also given in the offer documents. Investors should approach the concerned Mutual Fund / Investor Service Centre of the Mutual Fund with their complaints.

If the complaints remain unresolved, the investors may approach SEBI for facilitating redressal of their complaints. On receipt of complaints, SEBI takes up the matter with the concerned mutual fund and follows up with it regularly. Investors may send their complaints to:

Securities and Exchange Board of India Office of Investor Assistance and Education (OIAE)

Exchange Plaza, “G” Block, 4th Floor,

Bandra-Kurla Complex,

Bandra (E), Mumbai – 400 051.

Phone: 26598510-13

What is the procedure for registering a mutual fund with SEBI?

An applicant proposing to sponsor a mutual fund in India must submit an application in Form A along with a fee of Rs.1lakh. The application is examined and once the sponsor satisfies certain conditions such as being in the financial services business and possessing positive net worth for the last five years, having net profit in three out of the last five years and possessing the general reputation of fairness and integrity in all business transactions, it is required to complete the remaining formalities for setting up a mutual fund. These include inter alia, executing the trust deed and investment management agreement, setting up a trustee company/board of trustees comprising two-thirds independent trustees, incorporating the asset management company (AMC), contributing to at least 40% of the net worth of the AMC and appointing a custodian. Upon satisfying these conditions, the registration certificate is issued subject to the payment of registration fees of Rs.25 lakhs. For details, see the SEBI (Mutual Funds) Regulations, 1996.