A Guide to Understanding

Mutual Funds

IFEA

Investor Education Simplified

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Understanding Mutual Funds

To The Reader

IFEA is pleased to bring you A Guide to Understanding Mutual Funds. This guide, one of several in the IFEA's Investor Education Series, is intended to explain mutual funds and the basic principles of investing.

This guide is designed to increase your awareness of the benefits of funds and investing, and help you set realistic goals and expectations. If you would like to learn more, please visit our website at www.ifea.in

Introduction

Establishing realistic financial goals is an essential first step toward successful investing. Understanding the investments best suited to helping you achieve your goals is equally important. Most of us invest to meet long-term goals, such as ensuring a secure retirement or paying for a child's education, but many also have more immediate goals, like making a down payment on a home or car, a vacation to a dream destination.

Mutual funds can fit well into either your long or short-term investment strategy, but the success of your plan depends on the type of fund you choose. Because all funds invest in securities markets, it is crucial to maintain realistic expectations about the performance of those markets and choose funds best suited to your needs.

Six Basic Rules Of Investing

01 Diversify your investments

02 Understand the relationship between risk and reward

03 Keep short-term market movements in perspective

04 Maintain realistic expectations about investment performance

05 Consider the impact that taxes will have on your investment return

06 An investment's past performance is not necessarily indicative of its future results.

Mutual Fund

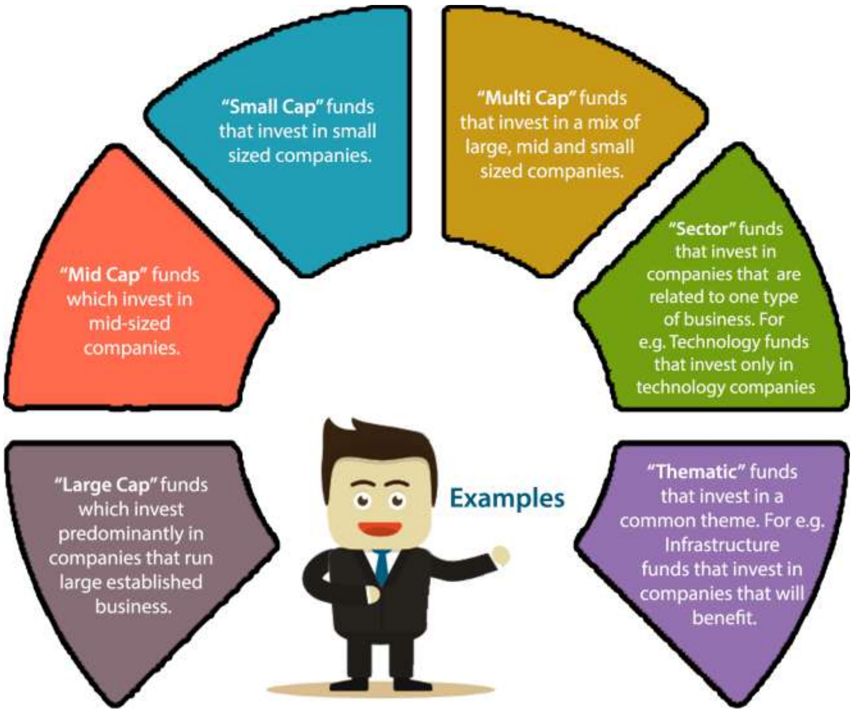
A mutual fund is a pool of money managed by a professional Fund Manager.It is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities.

The income / gains generated from this collective investment is distributed proportionately amongst the investors after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. Simply put, the money pooled in by a large number of investors is what makes up a Mutual Fund.

Different Funds and Different Features

Various types of Mutual Funds exist to cater to different needs of different people. Largely, they are of three types.

- These invest predominantly in equities i.e. shares of companies.
- The primary objective is wealth creation or capital appreciation.
- They have the potential to generate higher return and are best for long term investments.



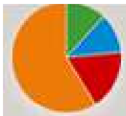
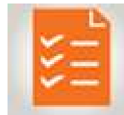
Income / Bond / Fixed Income Funds

- These invest in Fixed Income Securities, like Government Securities or Bonds, Commercial Papers and Debentures, Bank Certificates of Deposits and Money Market instruments like Treasury Bills, Commercial Paper, etc.
- These are relatively safer investments and are suitable for Income Generation.
- Examples would be Liquid, Short Term, Money Market, Dynamic Bond, Gilt Funds, etc.

Hybrid Funds

- These invest in both Equities and Fixed Income, thus offering the best of both, Growth Potential as well as Income Generation.
- Examples would be Balanced Hybrid Funds, Dynamic Asset Allocation, Equity Savings etc.

Large Cap Funds:


Invest a larger proportion of their corpus in companies with large market capitalization.	Well-established players with a good track record.	Generate wealth steadily over long term.

Advantages of investing in Large Cap:

1. Stable and Safe in comparison with Mid / Small Cap.

2. Can withstand a downturn in any business cycle.

Suitability

1. Ideal for investors with lower risk appetite.

2. For those who are investing in Equity for the First Time

SEBI Grouping

As per latest SEBI classification, a large-cap stock is 1st -100th company in terms of full market capitalization.

Multi Cap Funds:

- Multi Cap Funds invest across Large cap, Mid cap and Small cap stocks.
- While Large Cap stocks provides much needed stability, Mid and Small Cap stocks are expected to spice up the portfolio.
- It also takes advantage of both growth and value style of investment.

Different segments in the market tend to perform in different phases. Multi Cap Funds can take advantage of it and adapt their portfolios accordingly. Therefore, in the long run, Multi-Cap funds are better wealth creators with lesser volatility.

Large and Mid cap Funds:

As the name suggests, Large and Mid Cap funds hold a combination of Large Cap and Mid Cap stocks. While Large Cap stocks provides much needed stability, Mid Cap stocks are expected to add spice to the portfolio.

While a pure Large Cap Fund is suitable for a conservative investor looking for stable return with minimum risk, a Large & Mid Cap Fund is suitable for an investor willing to take slightly more risk for that additional return.

As per recent SEBi's norms, a Large & Mid Cap Fund should hold a minimum of 35% of the corpus each in Large Cap stocks & Mid Cap stocks.

Mid cap Funds:

Mid Caps are described as the investment sweet spot due to their ability to create sufficient wealth for an investor. These Companies are relatively more stable than Small Caps & have large room to grow than Large Caps.

- Whenever economy revives, Mid Caps will outperform Large Caps. One should invest in Mid Caps with a long-term view of around 5 years to realize the full benefit of embedded growth and value creation.
- Hence, investors who are not in need of their available surplus anytime in near future or whose retirement is decades away, should have an exposure to good Mid Cap funds .
- You can make volatility in these funds work in your favour by investing via SIPs.

For your information, many of today's Large Caps are yesterday's Mid Caps. Similarly, today's Mid Caps could be tomorrow's Large Caps.

As per SEBI's recent categorisation, 101st to 250th companies in terms of full market cap are grouped as Mid Cap stocks.

Focused Funds:

As the name suggests, Focused Funds maintain a concentrated portfolio of few stocks. It can focus on Large Cap, Mid Cap or adopt a simple Multi Cap Strategy.

Objective

To deliver increased return by investing in limited number of stocks.

Suitability

- As portfolio consists of select few stocks, Focused are more risky than diversified Equity Funds where investment typically will be made in more number of stocks.
- On the other hand, Focused Funds have the potential to deliver higher return if the select picks perform well.
- Hence, these funds are suitable for an aggressive investor willing to take extra risk for an increased return.

SEBI's categorization

As per recent SEBI'S categorization, Focused Funds can invest in a maximum of 30 stocks & shall mention the area of focus-Multi cap, Large Cap, Mid cap or Small cap.

Why Invest in a Mutual Fund?

Mutual funds make saving and investing simple, accessible, and affordable. The advantages of mutual funds include professional management, diversification, variety, liquidity, affordability, convenience, and ease of record keeping as well as strict government regulation and full disclosure.

Professional Management: Even under the best of market conditions, it takes an astute, experienced investor to choose investments correctly, and a further commitment of time to continually monitor those investments. With mutual funds, experienced professionals manage a portfolio of securities for you full-time, and decide which securities to buy and sell based on extensive research.

A fund is usually managed by an individual or a team choosing investments that best match the fund's objectives. As economic conditions change, the managers often adjust the mix of the fund's investments to ensure it continues to meet the fund's objectives.

Diversification: Successful investors know that diversifying their investments can help reduce the adverse impact of a single investment. Mutual funds introduce diversification to your investment portfolio automatically by holding a wide variety of securities. Moreover, since you pool your assets with those of other investors, a mutual fund allows you to obtain a more diversified portfolio than you would probably be able to comfortably manage on your own and at a fraction of the cost.

In short, funds allow you the opportunity to invest in many markets and sectors. That's the key benefit of diversification.

Low Costs: Mutual funds are permitted to charge / incur certain operating expenses for managing the scheme.

Within the limits specified by SEBI Expense ratio is calculated as % of scheme's average NAV. rate is 2 to 2.5%.

Liquidity: Liquidity is the ability to readily access your money in an investment. Mutual fund shares are liquid investments that can be sold on any business day. Mutual funds are required by law to buy, or redeem, shares each business day. The price per share at which you can redeem shares is known as the fund's net asset value (NAV). NAV is the current market value of all the fund's assets, minus liabilities, divided by the total number of outstanding shares.

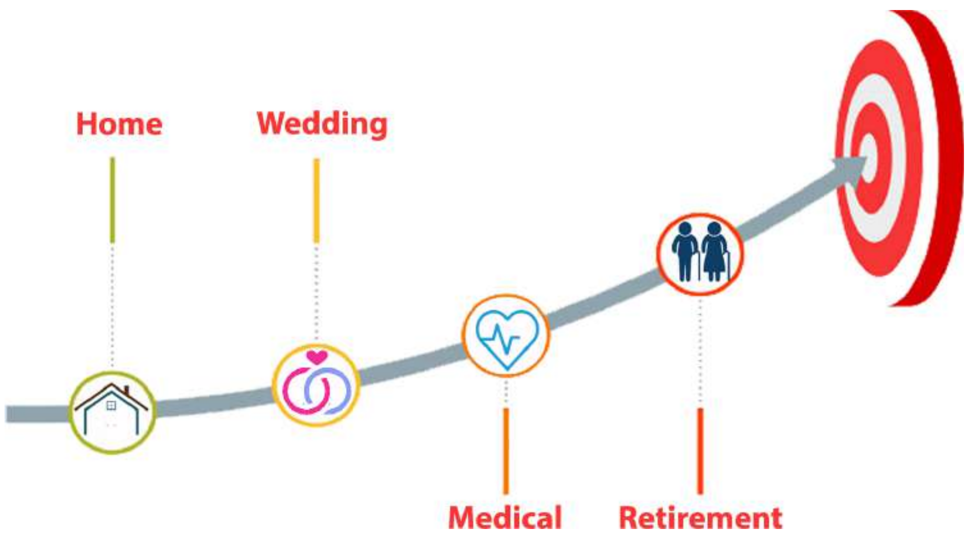
Convenience: You can purchase or sell fund shares directly from a fund or through a broker, financial planner, bank, over the telephone, and increasingly by personal computer. You can also arrange for automatic reinvestment or periodic distribution of the dividends and capital gains paid by the fund. Funds may offer a wide variety of other services, including monthly or quarterly account statements, tax information, and 24-hour access to fund and account information.

Variety: Within the broad categories of equity, hybrid and debt funds, you can choose among a variety of investment approaches.

Protecting Investors: Not only are mutual funds subject to compliance with their self-imposed restrictions and limitations, they are also highly regulated by SEBI.

Establishing Goals & Realistic Expectations

Determining your financial goals is the first step to successful investing. You may have immediate goals, such as making a down payment on a home, paying for a wedding, or creating an emergency fund. You may also have long-term goals, like paying for college or retirement. Establishing goals will help assess how much money you need to invest, how much your investments must earn, and when you will need the money.



The next step is to make a realistic investment plan designed to meet your goals. Setting realistic expectations about your investments and about market performance is an important part of your investment plan. Securities don't always rise in value, and when they fall, the downturns can sometimes be lengthy. A well-conceived, diversified personal investment plan can help you weather these downturns, and give you a measure of comfort when market volatility occurs.

Remember, also, that your plan should paint a broad picture of your personal financial situation now and where you want it to be in the future. In addition to goals, your plan should reflect your time horizon, financial situation, and personal feelings about risk. Establish your goals and create an investment plan now—the sooner you begin investing, the longer your money can to work for you.

Goals and Time Horizon

Generally, your goals will dictate how much time you have to invest. For example, if you are 35 years old and investing for retirement at age 65, then you have a time horizon of 30 years before you plan to begin withdrawing money. Identifying your time horizon is important because it influences how you invest your assets. Typically, a shorter time frame necessitates conservative investments, while a longer period allows you to handle more risk.

Risk/Reward Tradeoff

All mutual funds involve investment risk, including the possible loss of principal. Making an informed decision to assume some risk also creates the opportunity for greater potential reward. This fundamental principle of investing is known as the risk/reward tradeoff. When forming a plan, examine your personal attitude toward investment risk. Is stability more important than higher returns, or can you tolerate short-term losses for potential long-term gains?

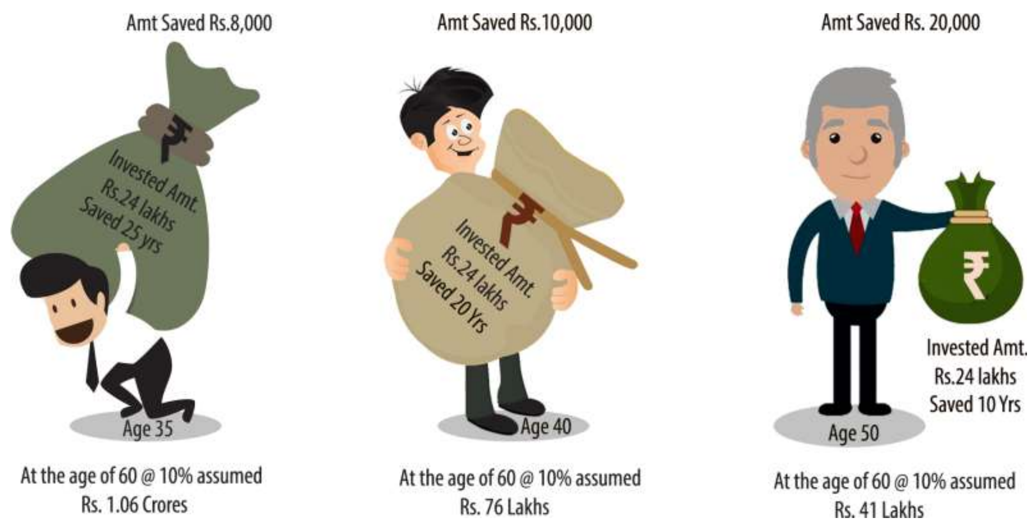
Remember, investments that increase in value in a short period can just as quickly decrease in value. But if you've considered the risk/reward tradeoff, you know that investment volatility is a characteristic of a successful long-term plan.

Start Investing Now To Take Advantage Of Compounding

Compounding is the earnings on an investment's earnings. For example, if you invest Rs.1,000 at a rate of 5 percent per year, your initial investment is worth Rs. 1,050 after one year. During the second year, assuming the same rate of return, earnings are based not on the original Rs. 1,000 investment, but also on the Rs. 50 in first-year earnings. Over time, compounding can produce significant growth in the value of an investment. So, the earlier you start investing, the faster your investments can grow in value.

Cost of Delay

Most people defer financial decisions. This applies not only to decisions on how and where to make the investments, but also to review periodically how their investments are performing. Did you know that there is a real cost to this behaviour? Let us understand this with an example:



It is assumed that investments are made in Equity or Equity related products.

Simple Tips:

1. Start now with what you have however small the amount may be.

2. Start with simple products and seek help to make the decisions if required.

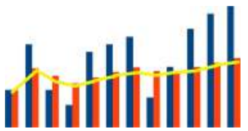
3. Automate your investments as far as possible so that you are not required to take action each time an investment has to be made.

Systematic Investment Plans

A systematic approach to long-term investing is called Rupee-Cost averaging. This refers to the practice of investing the same amount of money in the same investment at regular intervals (like once a month), regardless of market conditions. If you choose the rupee-cost averaging approach, the amount you invest is always the same. Thus, you automatically buy more shares when the price is low, and fewer when the price is high.

Your natural instinct might be to stop investing if the price starts to drop but history suggests that the best time to invest may be when you are getting good value.

Rupee-cost averaging can be an effective strategy with funds or stocks that can have sharp ups and downs, because it gives you more opportunities to purchase shares less expensively.

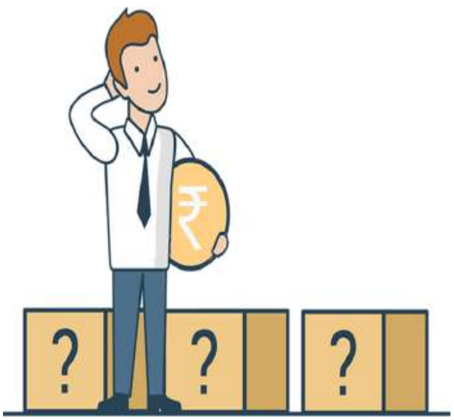


Systematic investment plans can make it easier to invest and can help you take advantage of the potential benefit of Rupee Cost Averaging.

The benefit of this approach is that, over time, you may reduce the risk of having bought shares when their cost was highest.

Instead, as the example overleaf, demonstrates, the average cost of your shares will be lower.

Saying No to Market Timing



"Buy low, sell high" may seem like good advice, but even the most experienced investors find it impossible to pinpoint market lows and highs with any degree of accuracy and consistency.

That's why experts advise putting a fixed amount of money into a stock or bond fund on a regular schedule rather than "timing the market." However, you should keep in mind that rupee-cost averaging can't guarantee a profit or protect against a loss in a declining market. So choose an amount you feel comfortable investing under all market conditions.

Let us understand this with an example:

Month	Amount Invested	NAV	No of units allotted
1	Rs. 5000	Rs. 125	40.00
2	Rs. 5000	Rs. 120	41.67
3	Rs. 5000	Rs. 123	40.65
4	Rs. 5000	Rs. 115	43.48
5	Rs. 5000	Rs. 110	45.45
6	Rs. 5000	Rs. 120	41.67
Total	Rs. 30000	Rs. 119	252.92
Lumpsum	Rs. 30000	Rs. 125	240.00

According to the table the total number of units bought could have been 252.92 while the cost per share has averaged out to Rs 119 per unit. If invested as a lumpsum 240 units would have been bought.

Investing in Mutual Funds through Stock Exchange Platform

You can now invest in MF through Stock Exchanges as you buy shares. It can be held in your existing Demat Account.

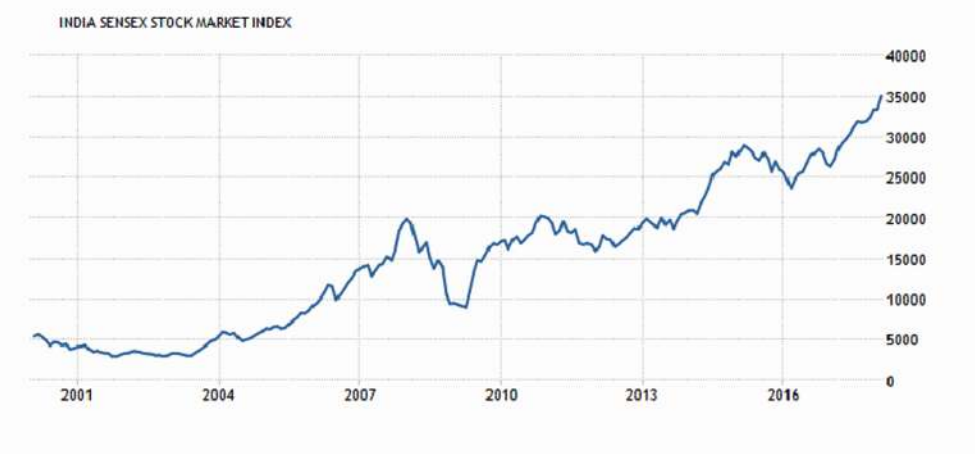
Establishing Realistic Expectations about Performance

A fund investment can help you reach your financial goals, but mutual funds and the stock and bond markets is not an automatic route to financial security. That's why an important part of your investment plan is having realistic expectations about your funds and market performance.

Bull and Bear Markets

- A bull market is a prolonged period of rising stock prices, and conversely, a bear market is a prolonged period of declining stock prices.

- Experts remind investors that it is unrealistic to expect stock market annual returns of 15 and 20 percent or higher.



Measurements of Performance

Total return is generally regarded as the best measure of fund performance because it is the most comprehensive. Total return includes dividend and capital gains distributions along with any changes in the fund's share price. A dividend distribution comes from the interest and dividends earned by the securities held by a fund; a capital gains distribution represents any net gains resulting from the sale of the securities held by a fund. Total return, expressed as a percentage of an initial investment in a fund, represents the change in that investment's value over a given period, assuming any distributions were reinvested in the fund.

Key Considerations about Performance

Past performance cannot predict future results. How a fund has performed in the past can't tell you how it will perform in the future. But it can give you an idea of how the fund has performed in different market conditions. Short-term returns may not tell the whole story. Looking at fund performance over a longer period, such as 10 years, can give you a better picture of how the fund has performed during market fluctuations, and how it compares to funds with similar objectives.

Track the performance of your mutual fund

Fund Fact Sheet:

A fund fact sheet is a document detailing each of the schemes managed by the AMC or the mutual fund. It is published monthly by the fund house and is in an easy-to-read format. It includes the following details:

- Performance of the schemes. It gives the performance in terms of compound annual growth rate or CAGR, standard deviation, Beta and Sharpe ratio.
- Division of your investments or how your money has been deployed in securities.

Size and investment details of each scheme managed by the mutual fund.

The fact sheet can be easily found on the mutual fund website and reviewing it is an ideal way to monitor your mutual fund investments.

Scheme vs benchmark

Every mutual fund scheme is mandated to have a benchmark. You should always compare the performance of a scheme against its benchmark. Comparing the performance of your scheme with its benchmark would give you a better idea about the performance of the scheme. If the scheme has managed to beat its benchmark, it shows that the fund has done well. If it has managed to beat the benchmark by a big margin, it shows that the fund manager has very good stock-picking skills.

Scheme vs category

The mutual fund scheme has outperformed its benchmarks. But is that good enough? Not necessarily. You should then proceed to compare its performance with its category. You can look at category average returns to find out whether your fund is an above average performer. You can also compare its performance with some established peers to figure out its standing in the category.

Look at the portfolio

Sure, the fund is an above average performer within the category. But is it bankable? You can proceed to take a look at its portfolio to find out the answer. Take a close look at the stocks in its portfolio. Are they in line with the mandate of the fund? Does the stock portfolio match your risk profile you had in mind?

Checking ratios

You can take a look at the important ratios of the fund. Mutual fund experts mostly follow ratios like standard deviation, mean, alpha, beta, etc. You can learn the basic function of these ratios and compare the ratios of a scheme with its peers to find out where the scheme stands vis-a-vis the peers.

Note:
You should review the portfolio once in six months or in a year.

The Risk of Inflation

It may seem logical that the safest investment is one that seeks to preserve your money, like certificates of deposit (bank CDs) or money market funds. While these instruments may play an important role in your overall financial plan, you need to be aware that they may not protect your assets against an easy-to-overlook risk—inflation.

WHEN PLANNING FOR FUTURE GOALS, IT'S IMPORTANT TO ALLOW FOR THE LIKELIHOOD THAT FUTURE EXPENSES WILL BE HIGHER BECAUSE OF INFLATION.

The Invisible Tax

Think of inflation as an invisible tax that erodes the purchasing power of any investment. For example, Rs. 1,000 in a deposit account earns 7 percent interest, but inflation is 5 percent per year. Although this money will earn Rs.70 in interest after one year, inflation cuts the actual worth of this Rs. 70 down to Rs.66.5. In addition, the initial Rs. 1,000 will also erode by 5 percent to Rs.950. Therefore, after one year, the account has a balance of Rs.1070, but due to inflation, its purchasing power is only Rs.1,016.50. This is the effect of inflation risk. To maintain an investment's purchasing power, its total return must keep pace with the inflation rate.

THE EFFECT OF INFLATION	
In this many years...	Rs. 1000 will be worth...
5	₹ 783.53
10	₹ 613.91
15	₹ 481.02
20	₹ 376.89
25	₹ 295.30
30	₹ 231.38
35	₹ 181.29
40	₹ 142.05
Assuming 5 percent annual inflation	

The Annual Review

At least once a year, it's a good idea to review your investment plan. Because different investments grow at different paces, your current distribution of money among stock, bond, and money market funds may no longer correspond with your original allocations. If this happens with your investments, you will probably want to consider whether to redistribute some money to bring your allocations back in line with your plan.

Changing Lifestyles

In addition to the annual review, whenever you make a major life change, it's time to reassess your overall financial situation. Some common examples of life changes:

- Most of these events are likely to affect your ability to invest, your time horizon, and your overall financial picture, both short-term and long-term.

- It's never easy to find the time to review your investment plan when you're in the midst of any of these life changes, but it's worth making the effort. You don't want to enter a new phase of your life with a plan that was designed for different circumstances.

- By staying on course with your asset allocations, you will help ensure that your overall portfolio continues to work effectively toward achieving your investment goals.

Tax Considerations

It is important to understand the impact that taxes can have on the return of any investment you choose. Taxes can especially affect the investment return generated in taxable investments.

The rates are applicable for the financial year 2018-19 .

Income Tax Implication on Dividend received by Unit Holders

	Individual / HUF
Equity Oriented Schemes	Nil
Debt Oriented Schemes	Nil
Dividend Distribution Tax(Payable by MF scheme)	
Equity Oriented Schemes	10% +12% Surcharge + 4% Cess = 11.648%
Money Market or Liquid schemes / Debt Schemes	25% +12% Surcharge +4 % Cess = 29.12%

Capital Gains Taxation	Individual / HUF
Equity Oriented Schemes	
Long term Capital Gains(units held for more than 12 months)	10%
Short term Capital Gains (units held for 12 months or less)	15%
Other than Equity Oriented Schemes	
Long term Capital Gains(units held for more than 36 months)	20% (after indexation)
Short term Capital Gains (units held for 36 months or less)	As per Income Slab