Understanding Mutual Funds

Table of Contents

Lesson 1
Concept, History and Type of Mutual Funds

Approximate Weighting – 10 marks

Key Aspects

- A mutual fund is a collective investment vehicle.
- Investors' contributions are denominated in units and invested in a portfolio according to the objectives of the mutual fund scheme.
- The value of a mutual fund unit changes with the changes in the market value of the portfolio.
- Net asset value is the current market value of a unit.
- UTI was the only mutual fund from 1963 to 1987. In 1987 the industry was open to public sector players. In 1993 the industry was opened to private and foreign players.
- Mutual funds can be open or closed-end in nature. Open-ended funds can be bought or sold at anytime. Closed-end funds are bought during the new fund offer and redeemed at maturity.
- Various categories of funds exist to serve various investment needs. The risk and return of these funds depend on the securities in which they invest.
- Liquid funds have the lowest risk and return; sector funds have the higher risk and return.

A mutual fund is a pool of investors' money

A mutual fund is a collective investment vehicle. It is a pool of investors' money invested according to pre-specified investment objectives.

Usually a mutual fund product is first described by its investment objective. Investors then invest their money in the product. The money is pooled together and is invested according to the stated objective.

Examples

- HDFC Income Fund is a debt fund that invests pre-dominantly in debt instruments, with the objective of generating regular income for its investors.

- DSPML Top 100 Equity Fund is a fund that seeks to generate capital appreciation from a portfolio of equity shares of the 100 largest listed companies.

Fund managers invest the pool of money into securities such as equity and debt, according to the stated investment objective of the fund. The risk and return of the fund depend on the investment objective of the fund.

The benefits from the investment of the pooled money accrue to those that contribute to the pool. There is thus mutuality in the contribution and the benefit. Hence the name 'mutual' fund.

Benefits to investors are according to their share in the pool

When a mutual fund pools money from several investors, each investor does not contribute the same sum of money. Depending on their needs and preferences, investors put in money into the fund. Therefore each investor's share in the pool of funds is not equal.

The benefits from the fund accrue to all investors in proportion to their share in the pool.

Example

- Three investors invest Rs 10,000, Rs 20,000 and Rs 30,000 respectively in a mutual fund. So the pooled sum is Rs 60,000.
- The money is invested and gains Rs 12000 over time. This means, the pool is now worth Rs 72,000.
- The value of the investors' holding in the mutual fund also goes up proportionately (in the ratio of 1:2:3) to Rs 12,000, Rs 24,000 and Rs 36,000 respectively.

Investors can contribute into a fund or redeem and take away their contributions, depending on the nature of the pool.

In a closed end fund, investors tend to stay until maturity. If a fund is open-ended, investors can come in and move out at will.

Therefore, there is the need to standardize the contributions of investors to be able to objectively measure their share in the fund.

Units Vs Shares

When investors subscribe to a mutual fund, they buy a share of the pool of funds. This share is called a unit of the mutual fund scheme. The investment in a mutual fund is represented to the investor in units.

A mutual fund investor is called a unit holder just as an investor in equity shares is called a share holder.

The ownership of the fund is jointly held by all the unit holders. Just as investors in equity hold shares of a company, mutual fund investors hold units of the fund.

Each unit has a face value. This is typically Rs 10 per unit for most mutual funds.

Equity shares are offered to investors for the first time in an IPO (Initial public offering). Mutual funds are offered for the first time to investors in an NFO (New fund offer).

Subsequently equity shares are bought and sold on the stock exchange. Mutual fund units can usually be bought and sold through the fund itself. Funds enable continuous transactions at their offices and at investor service centres.

Sometimes mutual funds are listed and can be bought and sold on the stock exchange.

The current value of units changes with the portfolio

A portfolio is a collection of securities. These securities can be equity shares, bonds, debentures, deposits, money market instruments, derivatives and the like. Mutual funds can invest only in marketable securities, or securities that can be traded in a market and therefore have a market price.

The value of the portfolio changes every time there is a change in market price of the securities a fund holds.

Consider this table:

Security	No of shares	Market Price Day 1	Market Value Day 1	Market Price Day 2	Market Value Day2
L&T	1000	2700	2700000	2900	2900000
Finolex	2000	53	106000	57	1140000
Sun Pharma	1000	1400	1400000	1300	1300000
ICICI Bank	1000	750	750000	700	700000
Total			4956000		5014000

As the market price of the shares it holds changes, the value of the portfolio has changed from Rs49.5 lakh to Rs.50.1 lakh. The value of the investors' unit holdings also changes along with the market value of the portfolio.

The current market value per unit is the net asset value (NAV). NAV can move up or down, depending upon whether the value of the portfolio has moved up or down.

Total assets less current liabilities are a fund's net assets

When we refer to total assets, we are referring to the value of the mutual fund portfolio. A mutual fund barely holds any other long-term asset in its balance sheet. As we shall see later, the offices other physical assets are not held in the fund's portfolio.

There may be few receivables and accrued income, which are current assets. These are added to the portfolio value to get the total assets of the fund.

Similarly on the liability side, a mutual fund does not have long-term liabilities. The assets are fully funded by the unit capital contributed by the investors.

Therefore when we refer to liabilities, we are referring to current liabilities, in terms of payables that may be due. The expenses associated with managing the portfolio are accrued as current liabilities and are paid as they become due.

Therefore net assets of a fund refer to the market value of the portfolio, plus accrued incomes, less any current liabilities and accrued expenses.

Net asset value (NAV) is a per unit representation of the net assets of a fund. NAV is a very frequently used term in the mutual fund industry. It refers to the current value per unit, deriving out of the current value of the mutual fund portfolio.

Calculations with respect to the NAV

Example 1

Net assets = Total assets minus current liabilities

The market value of a fund's portfolio is Rs 700 crore. If the current liabilities are Rs.50 crore, what are the net assets?

Net assets = Portfolio value less liabilities
= 700 – 50
= Rs 650 crore

Example 2

NAV = Net assets/number of units

Assume that the net assets of a fund are Rs 750 crore. The unit capital (face value Rs10) is Rs 250 crore. What is the NAV?

Number of units = Unit capital/Face value
= 250/10
= 25 crore units

NAV = Net asset /number of units
= 750/25
= Rs 30 per unit

Example 3

Net assets = NAV x number of units

If a fund's NAV was Rs 15 and the number of units was 100 crore, what are its net assets?

Net Assets = NAV x Number of units
= 15 x 100
= Rs 1500 crore

Mutual funds offer several advantages

The following are the advantages of mutual funds to investors:

- **Portfolio diversification** from securities spread over various companies, industries, issuers and maturities. The portfolio will not be affected by the bad performance of one or few of the securities.
- **Low transaction cost** from economies of scale. Since the fund invests large sums of money, the transaction cost comes down. Small amounts of investors get benefits of the large pool.
- **Professional managers** who are employed by mutual funds offer their expertise in managing the investors' funds, given their knowledge of markets and securities, according to the investment objective of the scheme.
- Portfolio diversification and the professional management of funds offer **reduction in risk** for the investor. The investment is always in a managed portfolio and not a single stock or sector.
- Investors can choose their investment to suit their particular needs and preferences. Minimum investment is low for most funds. Investors can choose systematic investment plans to invest regularly. Mutual fund transactions are **flexible and easy** to conduct.
- Mutual funds structure the portfolio in such a way that they are able to provide **liquidity** to the investor. Investors can take their money out when they need it.

Mutual funds are not customised for each investor

Mutual funds also have some disadvantages. Mutual funds are like pre-plated meals; there is no customised assembling of the meal by the customer. The mutual fund portfolio is a centralized pool, managed by fund managers and unit holders' hold their share in the commonly created and managed portfolio.

Some of the disadvantages of mutual fund investments are the following:

No control over costs

Investors have to accept the cost charged on their investments and cannot negotiate or control them. The costs incurred in managing the funds are however subject to regulatory limits and controls.

Customised portfolios are not possible

Mutual funds are standard products, managed centrally. There is no customisation. The NAV of the portfolio applies uniformly to all investors as on that date.

Customised portfolios are usually offered as portfolio management services (PMS).

Fund selection can be difficult

To the investor, making a choice among many funds becomes tough when so many variants of the same product are available in the market.

Quick Recap

A. Fill in the Blanks

1. The pool of money in a mutual fund is invested according to ______________ of the fund.
2. Investor's holding in a mutual fund is denoted by ___________.
3. Mutual funds invest in a portfolio of ___________.
4. Investing in a mutual fund enables __________________ and therefore a reduction in risk.
5. The value of each unit of the investor's holding in a mutual fund is denoted by _________.

B. State True or False

1. The value of the mutual fund unit depends on the value of the underlying portfolio.
2. An investor's ownership in the assets of a mutual fund is in proportion to their holding of units.
3. There is no limit on the expense that can be charged to a scheme.
4. Investors can get the portfolio of their choice by investing in a mutual fund.
5. The NAV of a mutual fund remains constant.

Answers

A. 1.Objectives 2.Units 3.Securities 4.Diversification 5.NAV

B. 1.True 2.True 3. False 4 .False 5. False