A Study on Choosing Mutual Fund Investments

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ABSTRACT

Mutual funds over a last 25 years have come to play an important role in one's personal financial planning. Mutual fund industry has been growing at a rate of 15% plus approximately. Due to the industry expansion, there are hundreds and thousands of mutual fund products in the marketplace. Many of these products come out with their own unique strengths based on ranking, rating and various performance parameters. Today, Investors are left with some bit of chaos / confusion in choosing an appropriate mutual fund to suit their personal needs. This presentation attempts to provide some clarity to individual investor while choosing mutual funds. The objective of this presentation is to throw light on choosing mutual funds based on individual needs and goals matching with one's own risk appetite.

Key Words:

Personal financial planning, ranking, rating, performance parameters, confusion clarity, risk appetite.

INTRODUCTION

Mutual funds contribute to economic development in multiple ways. They help firms and companies raise capital through buying shares and securities which in turn expand their businesses. Individual investor contributes to the pool of a mutual fund that shares the common investment objective. The minimum investment amounts can be as low as Rs.500 and move upwards depending on the type of mutual fund and the mode of investment. One of the primary objectives of Mutual funds is - it can give access to common man to invest in capital markets with small investment amount. Investors on a proportionate basis get mutual fund units for the sum contributed to the pool. Fund belongs to all the unit holders. The scope of mutual fund growth is huge in India.

OBJECTIVE

To throw light on choosing mutual funds based on individual personal financial needs matching their life goals and risk appetite.

How does a mutual fund work?

The investors give their money to fund house. The Fund house in return invests in various securities which generates returns. These returns are passed back to the investor.

HOW TO SELECT A MUTUAL FUND

The scheme selection is based on the following three factors:

1. **Asset class type:** Equity debt, etc.
2. **Scheme within the asset class:** Diversified, concentrated, schematic, etc.
3. **Option within the scheme:** Growth, dividend reinvestment, dividend payout

Before investing in any fund, goal identification, considering personal risk tolerance, desired time horizon, current income, short term and long term needs must be addressed. If a person is a aggressive risk taker, he invests in high risk investment product funds like Equities. If a person is a moderate risk taker, he invests in Hybrid or balanced funds. If a person is a low risk taker, he invests in liquid, ultra short term debt funds. One must not invest only on the basis of fund house, but determine each one's own needs. Past performance of a fund or a company is not a reliable indicator, but can give an access to the investor regarding volatility. It is important to understand the costs or expenses related to mutual funds as these can be the cause to lower the returns.

Merits of Mutual Funds

1. Professional Management

Once the investor invests in a fund, it is handled by the fund's money manager, who acts as a stock-picker. His responsibility is to attain returns consistent with the level of risk for a particular scheme. He keeps track of the market, trends in economy and securities in order to make informed investment decisions. He also buys and sells individual stocks and bonds from the portfolio as and when required.

2. Affordable Portfolio diversification

Diversification means mixing of various types of investments and asset classes within a portfolio which is used to manage risk. Since the securities are diversified, the investor is less likely to lose money on all investments at the same time. Due to this reduced portfolio risk is achieved.

3. Economies of scale

Since the money is pooled by many investors, it is possible for a fund to appoint fund managers who handles the portfolio management. As an individual, one cannot afford a fund manager. When securities are brought in bulk, one can enjoy the lower transaction fees.

4. Transparency

Mutual fund industry is regulated by SEBI where the companies require making necessary disclosures. The Net Asset value of the fund is updated on a regular basis, making the investor to keep track of the growth.

5. Liquidity

The investor can sell the units through stock exchange platform to recover the existing value of the investment.

6. Tax benefits

The Section 80 C of Indian Tax Act, allows a deduction of up to 1,50,000 from one's total annual income. Equity Linked Savings Scheme (ELSS) is tax saving mutual funds which has a lock-in-period of three years. This reduces taxable income and therefore tax liability.

7. Convenient options

Gives flexibility to investors to invest in mutual funds according to their liquidity needs, cash flow requirements and tax efficiencies. In addition, investors do have convenience of withdrawing part amts and also investing additional amounts at various frequencies.

8. Systematic approach to investments

The investor can invest on a regular basis through SIP – Systematic Investment plan, withdraw amount regularly through a SWP – Systematic Withdrawal Plan, which allows the investor to structure a regular cash flow from the investment account, move money between different kinds of schemes through a STP –Systematic Transfer Plan. These options promote investment discipline, which is beneficial in long-term wealth creation and protection.

9. **Regulatory comfort**

SEBI (Securities and Exchange Board of India), has mandated strict checks and balances in the structure of mutual funds and their activities. The investors benefit from such protection.

Demerits of Mutual Funds

1. Lack of Portfolio customization

Mutual fund investor cannot have the choice of specific shares or sectors as the portfolio is constructed and managed based on the fund managers expertise.

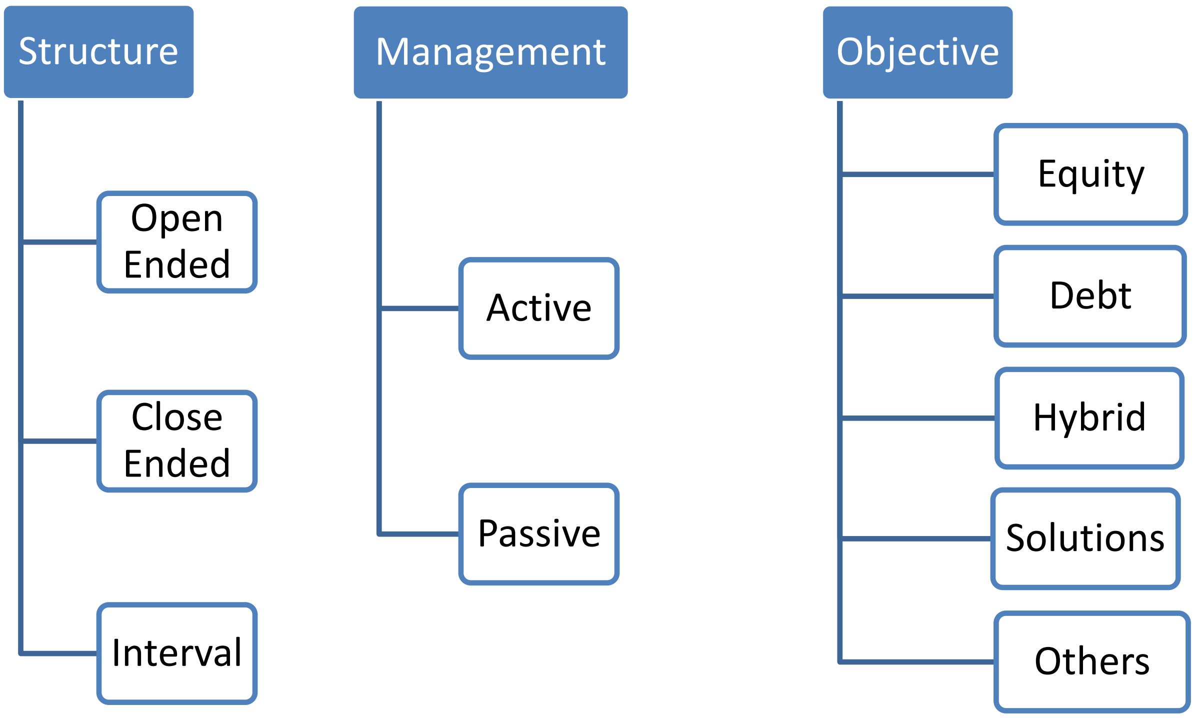
2. Choice overload

There are thousands of mutual fund products in the market. Hence, it is difficult for the investors to choose the products because of the overload of choices.

3. No control over costs

Since the costs are shared by all the unit holders as an individual one does not have any control over the costs incurred in the portfolio.

TYPES OF MUTUAL FUND



Based on Structure:

- ➢ **Open Ended Funds:** Funds where the investor can enter an exit at any point in time.
- ➢ **Closed Ended Funds:** Funds where the investor can enter only during NFO – New Fund Offer and exit on maturity.
- ➢ **Interval Funds:** The funds are largely closed ended, but have the facility of becoming open only during certain intervals.

Based on Management:

- ➢ **Passive Style:** The fund management style adopts and replicates any specific index. Fund management scope is less and expenses are comparatively lower.
- ➢ **Active Style:** This fund is completely fund management driven. Fund portfolio management is more active and tends to perform consistent with its own investment objective.

Based on Objective:

- ➢ **Equity funds:** More than 65% of the portfolio should have investments in equity or equity related instruments. As equity funds come with a quick growth, the risk of losing money is also relatively high. The returns are determined on the performance of shares.

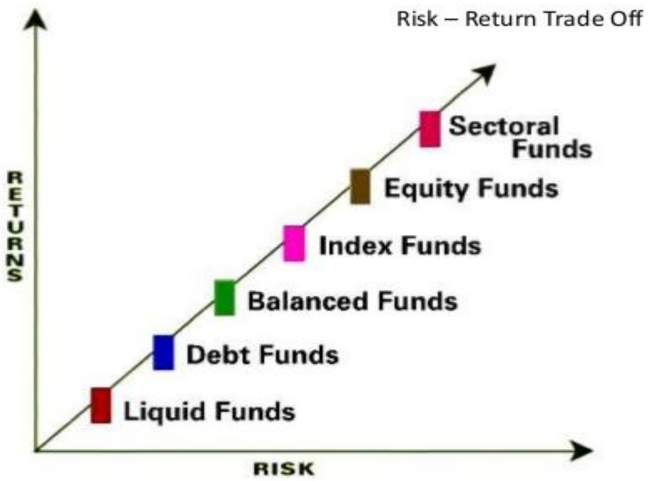
➢ **Debt funds:** These funds mainly invest in a mix of debt or fixed income securities such as Treasury Bills, Government Securities, Corporate bonds, and other debt securities of different time horizons. These finds have a fixed maturity date and pay a fixed rate of interest.

➢ **Hybrid:** Also known as 'Balanced Funds'. It ensures capital appreciation as well as strives to minimize potential risks. Hybrid funds provide an investment mix by investing in debt and equity instruments.

FACTORS INFLUENCING SELECTION OF MUTUAL FUNDS

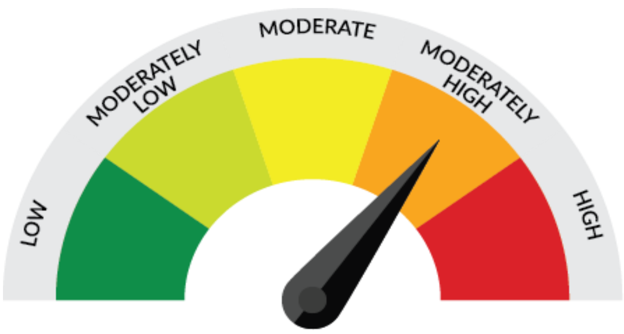
1. Risk level of investment

Investors must understand the risk level for each of the products mention and choose the products appropriately consistent with their respective goal.



Level of Risk	Definition	Example of the Type of Mutual Fund
Low	Principle at Low Risk	Liquid or Money Market Fund
Moderately Low	Principle at Moderately Low Risk	Fixed Maturity Plans/Capital Protection Oriented Scheme
Moderate	Principle at Moderate Risk	Short Term Income Fund/Conservative Monthly Income Plans
Moderately High	Principle at Moderately High Risk	Index Fund/Balanced Fund/Equity Dividend Yield Fund
High	Principle at High Risk	Sector Fund/Equity Focused Fund

RISKOMETER



2. Risk appetite of the investor

Factor	Influence on Risk Appetite
Family Information	
Earning Members	Risk appetite increases as the number of earning members increase
Dependent Members	Risk appetite decreases as the number of dependent members increase
Life Expectancy	Risk appetite is higher when life expectancy is longer
Personal Information	
Age	Lower the age, higher the risk that can be taken
Employability	Well qualified and multi-skilled professionals can afford to take more risk
Nature of Job	Those with steady jobs are better positioned to take risks
Psyche	Daring and adventurous people are better positioned mentally, to accept the downside risk
Financial Information	
Capital Base	Higher the capital base, better the ability to take the downside risk
Regularity of Income	People earning regular income can take more risk than those with unpredictable income streams

METHODOLOGY

The data is gathered from various sources like websites, mutual fund books, and interacting with industry experts. The collected data has been analyzed for a smooth flow of information matching with the objective of the presentation. Various pictorial representations related to products and other concepts have been picked from the above mentioned sources.

LIMITATIONS OF THE STUDY

1. The study would have been more effective with the support of primary data collection.
2. Time constraints for doing a perceptional study.
3. The scope of elaboration on the subject is huge; however, the study has been narrowed to the specific.

CONCLUSION

Mutual funds provide best investment options according to the investors' needs and requirement, when there is clear understanding about the suitability based on various risk-reward parameters. There is still long way for the mutual fund industry to reach large groups of people especially in rural and semi-urban areas. Creating awareness on investing and risks associated with mutual funds, helps in removing the misconceptions that public generally have and more and more people take a forward step to mobilize their savings in mutual funds.

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