Journal of Advances in Developmental Research (IJAIDR)
E-ISSN: 0976-4844 ● Website: www.ijaidr.com ● Email: editor@ijaidr.com

Mutual Funds: Meaning and Features

Dr. Rachna Garg

Lecturer
Department of ABST
Government Girls College, Dausa

Meaning of Mutual funds

A mutual fund is an investment vehiclewhich provides one with a chance to engage in financial markets even without much expertise.It collects/pools fundsfrom various investors and then invest those funds in a diversified manner. Funds are pooled from multiple individual investors as well as institutional investors. These collected funds are invested in mix of assets e.g. TREPS, receivables, shares or other securities. The mutual funds are managed by fund managers who have a high expertise and skill in the field of finance, the investment decisions are made by these fund managers on the basis of the objectives of the fund.

Mutual Fund Industries in India

The Unit Trust of India has marked the beginning of mutual fund industry in India with the collective efforts of Indian Government and the Reserve Bank of India. Since then, the Indian Mutual Fund Industry has witnessed a remarkable performance.Indian mutual fund industry started with traditional products like equity fund, debt fund and balanced fund and later significantly increased its product base. Today, the industry has introduced a wide range of products such as money market funds, sector specific funds, index funds, gilt funds, insurance linked funds, exchange traded funds, and marching towards reality funds. However, it is noteworthy that bulk of the mobilization has been by the private sector mutual funds rather than bank sponsored mutual funds in India.

Association of Mutual Funds in India has been established to protect the interests of mutual funds along with its unit holders and to ensure the development of Indian Mutual Funds Industry on ethical and professional lines.The Securities and Exchange Board of India (SEBI) regulates their operations in India. The Securities and Exchange Board of India's stated objective is "to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto." SEBI, being the regulatory body has also been entrusted with powers to conduct recovery proceedings, clarifications regarding insider trading, summon companies to depose before them, issuing guidelines for issue of shares, reporting from companies, etc.

Key Participants in Mutual Funds

The sponsor, trustees, Asset Management Company, custodian, Registrar and Transfer Agent (RTA), etc. are the major role player in Mutual Fund business. The sponsor is responsible for creating a mutual fund scheme and get approve it by The Securities and Exchange Board of India (SEBI). The sponsor also creates a legal entity in form of a Public Trust to be established under Indian Trust Act, 1882 and gets registered it with SEBI.The trustees approve the Mutual Fund scheme pre-launch and ensures that Asset Management Company (AMC) operates in the best interest of investors. Mutual Funds operate at the behest of Asset Management Companies (AMC) who designs a fund with a specific investment objective. The Asset Management Companies launches the schemes, appoints the Fund Managers, etc. Funds managers are there to manage these pooled funds who used to select securities to create a diversified portfolio in consonance with fund's objectives. The fund managers are responsible to look after the investment process and to check out managing the pooled investments. Funds managers take care to update the investors regularly about the fund's performance, holding, strategical changes, etc.

Investment and Divestment in Mutual Funds

One can invest in the fund by purchasing it's units at the current Net Asset Value (NAV) and can sell the units back to the fund at the prevailing NAV. Mutual funds are bought or sold at the end of each day at NAV. The NAV is the per unit value of the fund's net assets, arrived at as under:

$$\text{NAV} = \frac{\text{Total Assets} - \text{Total Liabilities}}{\text{Number of Outstanding Units}}$$

It is the price at which one can purchase and redeem the units of Mutual Funds. A lower NAV does not mean that a fund is cheap and similarly a high NAV does not mean that the fund is expensive.

Procedure for investment and redemption in Mutual Funds

There are two methods for investing in the mutual funds:

1. Lumpsum: As the name itself indicates, a rather big amount is invested in a single stance.

2. Systematic Investment Plan: It is a disciplined way of investing small amount over an extended period in tranche at regular intervals.

Expenses on Investment and Redemption of Units under Mutual Fund Scheme

The mutual funds charge an annual fee from its investors to cover its operational and management costs incurred during the year. The expense ratio is deducted from the NAV on a daily basis, so it can be said that higher the expense ratio higher the deduction will be from the NAV and lower the expense ratio lower the deduction will be from NAV.

When buying or selling a mutual fund a cost is incurred known as the 'load fee' which is in addition to the expense ratio, the load fee is considered as a sales commission. The load fee paid at the time of purchasing the units in mutual fund scheme is known as 'entry load' and the load fee paid at the time of redemption/sale is known as 'exit load'. However certain funds don't charge exit load when it sold after holding for a pre-determined specified period.

However, investors do not consider expense ratio and management fee as worthless because of the pool of research, professional management, analytical skills, etc. they get in turn.

Type of mutual funds

There are various kinds of mutual funds and each of them have different objectives, which are:

1. Debt fund: These funds generally invest in bonds, debts and some other fixed income securities which carry low risk. These bonds, debentures and fixed income securities are generally those which carry a pre-determined fixed interest rate and are of long duration.

2. Sectoral funds: These funds generally invest in specific sectors like defence sector, railway sector, steel sector, etc.

3. Equity funds: These funds allocate majority of their funds in equity. These funds are generally riskier as compared to other funds but also have a potential to provide better returns.

4. Hybrid funds: These funds allocate their funds in both equity and debt. These are riskier and provide better returns than the debt funds but are less risky and provide less returns than the equity funds.

5. International funds: These funds invest in shares and other securities of foreign markets. However, there is a risk that the returns derived from these international funds and their overall value will decrease if the rupee appreciates.

6. Money market funds: Money market funds invest in short term debt instruments like commercial papers, treasury bills, etc. which have a high liquidity and carry low risk. These funds provide better returns than savings accounts and are also stable. Unlike debt funds, money market funds are not for long duration.

7. Index funds: Unlike other funds, index funds don't allocate their resources on stocks picked up by their fund managers but instead put the resources in the stocks of an index in the same proportion. These funds aim to provide returns of the index, they try to replicate the performance of the index. Since these funds replicate the performance of the index, they neither outperform nor underperform the index. These funds are not affected by the fund manager's bias. The risk involved with these types of funds is that if the index includes a share that is underperforming then the index fund will also have to include that share in its portfolio. The underperforming share cannot be removed from the portfolio or cannot be reduced the allocation, will have to be hold in the same proportion as the index.

Features of mutual funds

1. Variety: There are various kinds of mutual funds available in the market for investment, some invest in bonds, some in growth stocks, some in blue chips and etc. The risk appetites of mutual funds can be categorised into 3 kinds:

   a. Conservative: Investors who want good return while taking minimum risk are the ones who generally invests in mutual funds that carry a conservative approach.

b. Moderate: Investors who have a moderate risk tolerance choose the mutual funds that carry a moderate risk approach. The investors who opt for moderate approach mutual fund have an appetite to accept some volatility and desire better returns as compared to conservative fund investors for taking this risk.

c. Aggressive: The investors who want very high returns chose the mutual funds that have an aggressive approach, these investors take a lot of risk and faces a lot of fluctuations in their investment.

2. Diversification: Mutual funds invest the funds they collect from the investors in various kind of assets and have a diversified portfolio.This diversification helps them to ride the tide of market fluctuations and face the minimum jerk of downtrends in the market.

3. Affordability: A very less amount is required to make an investment into mutual funds. So, people having less cash at their disposal for making investment can participate and invest in these funds. So, it can be said that low minimum investment requirements make it affordable and easier for investors to invest in these funds.

4. Expert management: The mutual funds are managed by fund managers who have a lot of knowledge, skill, expertise and experience in the field of finance and markets.

5. Liquidity: Mutual funds are liquid and can be bought and sold at the NAV prevailing on the concerned day.

Benefit of Investment in Mutual Funds

1. Investment in mutual funds can be started with small amount.

2. Investment is appealing owing to the low cost.

3. There is a flexibility to move one's investment to a varied fund falling under the same fund house.

4. Investors are need not to be well conversant with the capital market as investments are handled by the experts.

5. Mutual funds are highly liquid. The entry and exit are very easy.

6. Mutual funds offer transparency owing to SEBI regulation.

Reasons of reluctance for investment in mutual funds

Like derivatives, retailers fear and hesitate to invest in mutual funds also.There are various reasons for this fear and hesitation which can be described as follows:

1. Lack of knowledge: Many retailers lack knowledge regarding mutual funds, various scheme thereof, etc. Even, many of them aren't aware of difference between shares and mutual funds and view these funds as a risky instrument for investment.

2. Preference bias: Many Indians prefer fixed deposits, gold and silver over mutual funds because they consider them to be more safe and secure.This bias makes their participation in mutual funds low.

3. Complexity: Different mutual funds have different approach, different objectives, different allocation of funds, which makes it complex for the individual retailers to understand them.

4. Effect of volatility: Unlike fixed deposits mutual funds reacts to the market volatility, this creates a fear of losing money among the real investors.

However, these fears can be eliminated by addressing the concerns of the retail investors and educating them about mutual funds, this will help in increasing the participation of retail investors in mutual funds in the future.

Malpractices in Mutal Fund Industry:

Malpractices by mutual funds are not uncommon and have been surfaced at times. Some of such unethical practices which undermine investors' trust, unstable the trading environment, manipulation the market, erode the trust in the financial system include the followings:

1. Insider trading: Utilizing non-public information for personal gain.
2. Front-running: Placing personal trades ahead of large client orders to profit from the price movement.
3. Misrepresentation and fraud: Making false or misleading statements about the performance or risks of mutual funds.
4. Time-sensitive trading: Trading mutual fund units at preferential prices based on when the trades were placed.
5. Churning: Excessive trading of an investor's account to generate commissions for the broker.
6. Embezzlement: Stealing or misusing funds belonging to the investor.
7. Money laundering: Concealing the source of illegal funds by investing them in legitimate businesses, including mutual funds.
8. Misuse of client information: Using client data for unauthorized purposes, including trading or spamming.
9. Bribes and kickbacks: Offering or accepting illegal payments to influence investment decisions.

However, these malpractices can be addressed with strong regulation, increased transparency, investor education, etc. In India, SEBI regularly comes out to crackdown on unethical practices in the mutual fund industry. According to clause 7 of the code of conduct as specified in the Fifth Schedule to SEBI (Mutual Funds) Regulations, 1996, the mutual funds should not use any unethical means to sell, market or induce any investor to buy their schemes.

Tax Implications of Mutual Funds

Mutual funds are financial products that generate returns which can be taxed. The taxation on mutual funds depends on the asset type, holding period of investment, etc. Some mutual funds known as Equity Linked Saving Scheme (ELSS) are specifically for the purpose of tax-saving benefits with a moderate lock-in-period.

Conclusion

Mutual Funds provides diversified investment opportunities by minimising risks and maximising potential returns under monitoring of experts.For making an investment in a highly sophisticated and complex financial market, investors need the support of financial experts to take an informed decision. Investment in mutual funds proved to be advantageous to those investors who are ready to take higher risk in order to earn higher return but they lack adequate knowledge of the market. It is the most suitable investment option for small investors who do not have sufficient capital, as it enables them to invest in blue chip companies.However, while investing in mutual funds, the disclaimer should be kept in mind that ‘Mutual Fund investment are subject to market risks’. The investors are supposed to apply their wisdom in choosing right mutual fund scheme suitable to their availability of investible fund, object of the investments, expectation from the mutual fund house and should read all scheme related documents carefully.

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