

ASPECTS

Mutual Fund *Mystique*

ASPECTS

is a periodic newsletter discussing finance, investments and the economy

Issue II

What are mutual funds

How do they work

What are the benefits to investors

What are the risks

Mutual Fund is a

- ♦ *Selection of securities*
- ♦ *Professionally managed & SEBI regulated*
- ♦ *Service at a cost*



Mutual Funds

are perhaps the most common securities investment vehicle for retail investors and are commonly employed by corporates and institutions as well.

In this edition, we discuss a few important aspects of mutual fund investing. So if this is something you've been thinking of or waiting to get at, read on

What is a mutual fund?

Mutual Funds (MF's) are a selection of stocks or bonds or another chosen asset class, that are marketed as a unit.

Let's consider a stock based mutual fund as an example. In this case, the fund manager evaluates a large pool of



companies and selects the few (~20-100) that in his judgement meet the objectives of the mutual fund scheme.

So if you are buying 100000 worth of MF shares you are buying shares of underlying companies in the same proportion in which they have been selected by the MF manager. You are paying the weighted average price as per the underlying shares (adjusted for fees, premium to NAV etc.) and if those shares appreciate, your MF investment will also increase in value.

In selecting shares of select companies the fund manager is arguably “diversifying risk”. What this means is since he is selecting several stocks instead of the 1-2 most promising ones (in his judgement), he is protecting assets from an unexpected deterioration in price of those 1-2 most promising stocks. Conversely, if those 1-2 stocks were to appreciate significantly, he is foregoing that gain. Most likely, he does so because he believes there are several stocks (instead of 1-2) that are about equal in potential and/or he knows that estimating stock potential is inherently subjective - there are several factors impacting company performance & stock prices and that his judgement could be off.

Benefits

- ♦ *Participation in income and/or growth potential of securities*
- ♦ *Low cost convenient entry and exit*
- ♦ *Usually diversified*

The fund manger team buys and sells shares over time and the net realized profit, including dividends and interest is periodically reported, and some or all of it is usually distributed to investors. The team also performs several other functions - manages cash inflow from/outflow to investors (MF customers), manages fund finances, accounting, marketing, compliance and customer service etc.

Many of us do not have the time, or the inclination, or the expertise to spend time evaluating companies, their share prices etc. and in a sense the MF team is providing this service to us. For this service, they charge a fee that usually varies between 1-2.5% of the assets under management.

In other words, an equity based mutual fund allows an



Primary Risks

- *Inherent risk of underlying asset class*
- *Fund strategy & implementation*
- *Timing of purchase & sale*

investor to invest small (~ 500) or big amounts and participate in the income and/or appreciation potential of stocks. It does so while providing SEBI regulated and professionally managed investment platforms and convenient ways to monitor performance and exit (sell investments) at relatively minimal cost. As many as 42 companies offer mutual funds in India and as such, investors have a diverse basket to select from.

What are the risks of investing in MF's

There are several risks involved in MF investing that one should be aware of and factor into his or her decisions. We'll talk about a few important ones.

Firstly, investments are subject to all of the risks inherent in the underlying asset class adjusted for MF risk management strategies e.g. if the equity market drops, MF prices are also likely to drop, more or less so, depending on the specific selection of stocks and risk mitigation undertaken by the MF manager. Similarly if interest rates were to rise, then a bond mutual fund investing primarily in long term bonds would likely see a downward price adjustment.

The second risk is in the effectiveness of the MF strategy in selecting, holding and selling securities i.e. did the MF select the right securities, did it sell them at an appropriate time etc.

Effectiveness of strategy is reflected in fund performance over time. Even if the market is doing well, the MF maybe underperforming its benchmarks. In fact, several funds do worse than their chosen benchmarks over selected time periods.

Thirdly, from an investor standpoint there is a risk of buying or selling a good MF at a wrong time e.g. buying when prices are unrealistically high. Then, there are risks associated with excessive costs eating into returns, taxes on periodic distributions being ignored by investors, liquidity in the markets, amongst others.

In general, it is recommended that investors carefully read fund prospectuses, understand risks themselves and/or consult their advisors before making any investment decisions.

About us

NORTHPLAINS CAPITAL PARTNERS LLP offers investment solutions for clients including a combination of advice and active management

For customised solutions, research and advise, or to discuss ideas for preserving and growing your wealth, please contact us and we would be pleased to arrange a discussion

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NORTHPLAINS CAPITAL PARTNERS LLP was incorporated as a limited liability partnership in May 2017 under the Companies Act of India offering investment management solutions in addition to other services

Partners

Ramesh Chand Sud, has been a small business owner for the last 30 years in Shimla. He is also the Chairman of Shimla Nursing College and a respected social worker. Before joining his business he was an Officer at the office of The Accountant General

Nitin Sood, CFA manages the day to day affairs of the company. He has worked with multinational banks in North America for more than 10 years. He holds the Chartered Financial Analyst designation from CFA Institute Charlottesville, USA, an MBA from IIM Bangalore and a Bachelors in Engineering from Delhi College of Engineering

Baseline data sources

Mutual Funds in India : www.amfi.com

Disclosures

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