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What Are Mutual Funds?

Mutual funds need little introduction today. There is a good chance you already have some idea about them, and you may even be investing in them. The widespread coverage of mutual funds in the media has turned them into a mass investment product. That said, it is still worthwhile to revisit the fundamentals at the start of this learning journey.

A mutual fund is an investment product that collects money from many investors and invests it in a portfolio of securities managed by a professional fund manager. This portfolio may include different types of assets such as equity (shares or stocks), debt (bonds) and gold.

Each investor receives units of the mutual fund according to the current price of one unit, known as the Net Asset Value (NAV). You can usually buy or sell these units at any time, subject to the terms of the specific scheme. When the selling price is higher than the purchase price, you earn a profit.

The total value of all the money invested in a mutual fund is called Assets Under Management (AUM). The fund charges its investors a small annual fee known as the expense ratio for its services. The companies that operate mutual funds are called Asset Management

Companies (AMCs) or simply fund houses.

To start investing in mutual funds, you need to complete your KYC (Know Your Customer) formalities. KYC is a basic documentation process in which you provide details like your PAN, address proof, identity proof, contact details and so on. This process can be done both online and offline. For online KYC, you can visit any mutual fund website or the websites of mutual fund registrars CAMS and KFin Technologies. For offline KYC, you can visit their offices. KYC is a one-time process. Once it is done, you can seamlessly invest in any mutual fund across any fund house.

Mutual funds have two types of plans: regular and direct. In a regular plan, your money is routed through a distributor or intermediary, and the fund pays them a commission for their services, which is built into the expense ratio you bear as an investor. In a direct plan, you invest directly with the fund house and thus avoid this commission, resulting in a lower expense ratio. These plans, in turn, have two options: growth and IDCW. In the growth option, your capital remains invested and any gains are reinvested in the fund, so you do not receive any interim payouts. IDCW stands for Income Distribution cum Capital Withdrawal. In the IDCW option, you receive interim payouts at the AMC's discretion.

Mutual funds come in a variety of formats and choices, but broadly there are four types of funds: equity, debt, hybrid and passive funds. A more recent addition to the Indian mutual fund universe is life cycle funds, which are meant for goal-based investing and typically adjust the asset allocation as you move through different life stages.

Equity funds predominantly invest in stocks or shares of companies. They have a high-return, high-volatility profile and are suited for long-term investments of, say, five years and above. This makes them a powerful wealth-building tool in your portfolio. However, do note that there are no guaranteed returns with mutual funds. Your actual returns will depend on overall market performance, the fund's performance and, of course, your own investment behaviour.

Debt funds mainly invest in bonds and other fixed-income securities. They generally have a lower return profile but usually carry less risk than pure equity funds and tend to be less volatile. Debt funds can be used for your short-term investment needs of up to three years. They can also have a long-term role to play in your portfolio by helping with asset allocation and stability.

Hybrid funds lie in between. They invest in both stocks and bonds or other fixed-income securities. Multi asset allocation funds, a sub-category of hybrid funds, also take exposure to gold, silver and sometimes real estate. The risk–return profile of hybrid funds lies between pure equity and pure debt funds. They are often ideal for investment durations of about three to five years.

Finally, there are passive funds, which include index funds and Exchange-Traded Funds (ETFs). These are called passive instruments because they simply seek to replicate an underlying index instead of actively trying to beat it. Another class of passive funds is Funds of Funds (FoFs). They are considered passive in the sense that they invest in other funds rather than directly in individual securities.

Under these broad categories, there are numerous sub-categories, and SEBI keeps refining and updating them from time to time. This multitude of sub-categories across a multitude of fund houses has severely crowded the mutual fund space, making it difficult for investors to pick the right one for themselves. Fortunately, as we will see in this book, you do not need most of these sub-categories. For now, let us take a look at the advantages of mutual funds.

Advantages of Mutual Funds

The first advantage of mutual funds is that you get to benefit from the expertise of the fund manager. Fund managers are investment specialists with relevant education and years of experience. By investing in a fund, you do not have to do the heavy lifting yourself. All you need to do is entrust your money to the fund, and the fund takes care of the rest: picking the right securities, managing them and exiting them at the right time, among other things. This makes investing quite convenient, especially for those who do not have the time or interest or both to handle their own portfolios.

The second benefit is automatic diversification. In essence, a mutual fund is a portfolio of securities. When you invest in a fund, your money is automatically spread across that portfolio. This means ample diversification, irrespective of your individual investment amount.

The third advantage is variety. Mutual funds come in many shapes and sizes and thus offer a wide range of choices. There are equity funds, debt funds, hybrid funds, gold funds, silver funds, index funds and so on. You can pick the right fund for yourself from this wide bouquet of options, depending on your requirements.

Next comes convenience. It is quite easy to invest in a mutual fund. Once your KYC is done, you can seamlessly invest in any mutual fund via fund house websites, MFCentral, authorised apps, brokers and other intermediaries. The investment process is largely online and works smoothly for most investors.

Another advantage of mutual funds is transparency. Indian mutual funds are highly transparent and are regulated by the Securities and Exchange Board of India (SEBI). Mutual funds are required to make regular public disclosures regarding their portfolios and other key information, which keeps investors aware of what is happening with their money.

The fifth benefit of investing in mutual funds is tax efficiency. Mutual funds are structured as pass-through entities. This means they generally do not have to pay tax when they sell their underlying securities at a gain; instead, the tax liability typically arises at the investor's level. On the other hand, if you were to maintain a portfolio on your own and buy and sell securities directly, you would have to pay capital gains tax on each profitable transaction, depending on the rules. This does not automatically mean that there is no tax on mutual funds. As an investor, when you sell your fund units at a gain, you may have to pay tax as per the applicable rules.

Then comes the benefit of flexibility and liquidity. For most mutual funds, you can easily redeem your units or shift your money to another mutual fund, subject to any applicable exit loads or conditions. The redemption proceeds are credited directly to your bank account. Mutual funds also offer Systematic Investment Plan (SIP), Systematic Withdrawal Plan (SWP) and Systematic Transfer Plan (STP), which further enhance their appeal for investors.

However, this is not to suggest that mutual funds have no risks or disadvantages. For the complete picture, let's also look at the other side.

Disadvantages of Mutual Funds

Mutual funds are subject to market risks and their returns are heavily influenced by market movements. If the stock market falls, chances are that equity funds and other funds investing in equity will also fall. If the bond market turns jittery, debt funds and other funds investing in bonds will come under pressure. If gold prices decline, gold funds are likely to fall as well.

How much a fund falls also depends on the selection of its securities and the expertise of the fund manager. A good fund is one that does not fall as much when the market falls but participates fully when the market does well. Indeed, downside protection is an important objective for any actively managed fund.

There are no guaranteed returns in mutual funds. Returns depend on market factors and the performance of the underlying securities in the fund's portfolio. So mutual funds are not like bank fixed deposits or small-savings schemes that promise definite returns. But do note that guaranteed returns also tend to be lower and, in inflation-adjusted terms, can even be negligible.

Mutual funds – especially equity funds or those investing heavily in equity – can show sharp movements if the market goes into a tailspin. This volatility is difficult to bear for many investors. However, as the holding period of your investments increases, the impact of market volatility tends to dampen. That is why it is recommended that you keep a long-term horizon while investing in equity funds.

As we saw earlier, choosing the right fund from the multitude of categories can be challenging and can lead to wrong choices, which in turn can affect your financial outcomes. Apart from the number of categories, confusion also stems from the number of AMCs. There are dozens of AMCs, and picking the right fund from the right AMC is not easy. But that is exactly why this book has been written.

In the next chapter, we will discuss the concepts of asset allocation and rebalancing, which lie at the heart of all investing, including investing in mutual funds.