



*Guidebook on*

# Mutual Funds



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# Chapter 1: Mutual Funds Basics



This chapter is a basic introduction to the salient features of mutual funds, and the basics regarding their workings and their selection from the point of view of investors.

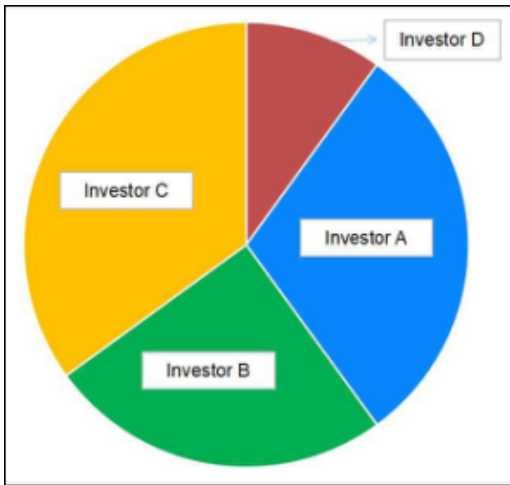


# 1. What is a mutual fund?

A mutual fund is an investment program that is **professionally managed and diversified in its investments**.

The process involves professionals using the funds of retail investors to invest in a **carefully selected set of investment products** to build a diversified portfolio. The professionals who are responsible for managing a mutual fund are known as **fund managers**.

**A fund manager** is an expert who is well versed with how the stock market works. He/She aims to build a portfolio that performs a certain market index.



Suppose you wanted to buy a pizza, but you have money that's worth half the cost of the pizza. The only solution here would be to find another person, who is interested in buying the other half of the pizza with you.

Why? Because -

1. The pizza shop will not sell you only half a pizza; and
2. Doing so will get you the exact amount of pizza you wanted, at the exact amount of money you wanted to spend.

## 2. What are the advantages of mutual funds?

### Simple Concept

The concept and management of a mutual fund investment is very simple. You choose the fund and invest in it, and the rest of the decisions will be handled by the fund managers.

### Variety of Products

The mutual fund industry offers a huge amount of schemes. They are built to cater to the different types of investors present in the market on the basis of time duration of investments, and the risk appetite of investors.

### Diversifying our Portfolios

A mutual fund is a set of different types of investment products. When we put our money in a mutual fund, we automatically diversify our portfolio.

### Professional Fund Management

The biggest advantage of putting our money in a mutual fund comes from the professional management that our investment receives.



### 3. How does a mutual fund investment work?

To invest in a mutual fund, one needs to purchase the units of a mutual fund. The price of one unit is called the NAV (Net Asset Value).

For example, say the price of petrol is Rs 70 currently. Therefore, for one litre of petrol, you will have to pay Rs 70. Similarly, for one unit of a mutual fund, you will have to pay the NAV of the fund.

#### So, how is a NAV calculated?

In mathematical terms:

$$\text{NAV} = \frac{\text{Assets of the fund} - \text{Liabilities of the fund}}{\text{No of units held by all investors}}$$

To explain simply, it is basically the market price of the units held by investors. Hence, the performance of a mutual fund scheme reflects in its NAV.

This NAV is affected by the market from where the securities are purchased.



### 4. What are the various factors to be considered while choosing a mutual fund scheme?

The various factors are as follows -

#### i. Time horizon

The time horizon is the period for which the investment is to be made. The period could range from 1 day to as much as more than 5 years. For long term, equity should be chosen and for short term debt instruments should be chosen.



## ii. Risk Tolerance

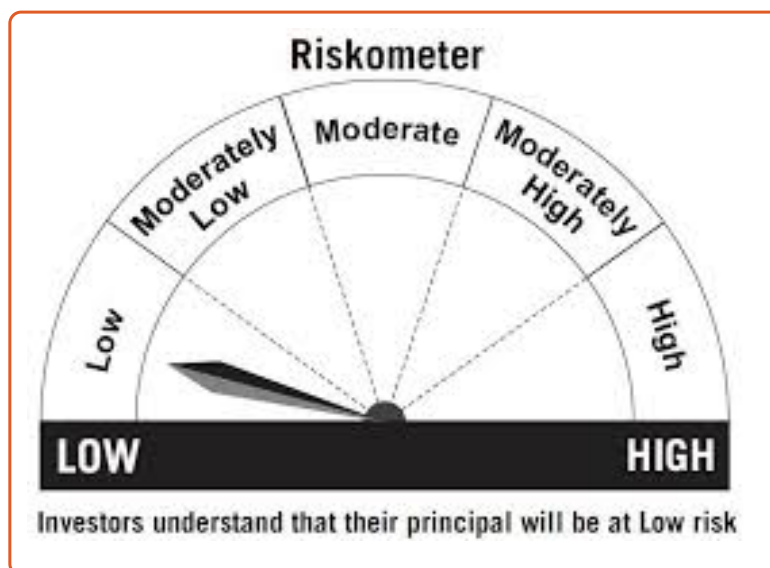
For a risk-taking investor, a volatile fund like a small cap fund can be chosen and for a risk adverse investor a large cap fund may be chosen. The best and the quickest way to identify the risk appetite that the mutual fund serves is by looking at its risk-o-meter.

A **risk-o-meter** is a graphical representation of the risk involved in a mutual fund.

It helps the prospective investor to understand if the risk level of mutual fund scheme matches with that of his own.

It contains 5 levels of risks -

- a. Low;
- b. Moderately low;
- c. Moderate;
- d. Moderately high; and
- e. High.



Following are examples of some of each category-

Risk Profile	Types of Funds
Low Risk	Liquid Funds
Moderately Low Risk	Short-duration Funds, Ultra Short-duration Funds
Moderate Risk	Fixed Maturity Plans
Moderately High Risk	Large Cap Funds, Mid and Small Cap Funds, Balanced Funds
High Risk	Sector Funds



### iii. Performance against category

Another way to find the best mutual fund is to compare its performance against the other schemes in that category. It should be remembered that comparison must be made between the schemes of the same category. For instance, a large cap fund must be compared with other large cap funds and not with small or mid cap funds.

### iv. Consistency of performance

A mutual fund should generate good returns for its investors on a regular basis and not just a one off good performance. We should look for a fund that provides decent returns in both bull and bear markets.

### v. Fund manager experience

The educational qualification and the duration for which the fund manager has been managing that fund should be considered. His past record should be tracked as well.

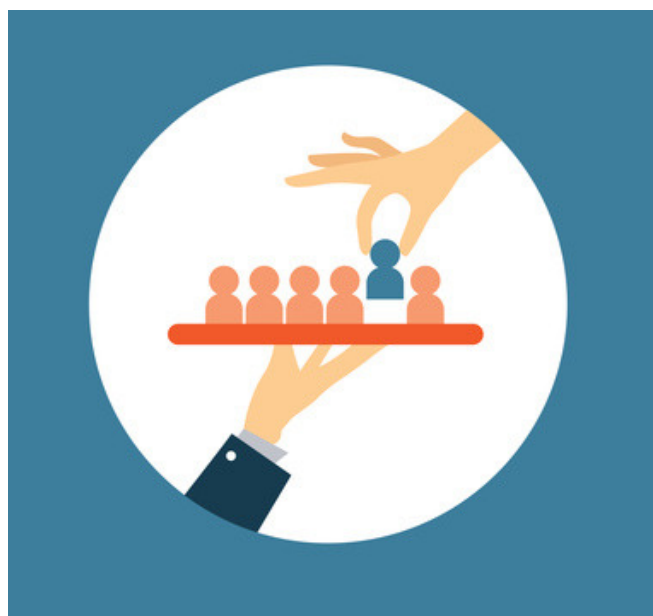
### vi. Expense Ratio

This reflects the fee which is charged by an AMC for the fund management and other costs related to the fund.

Naturally, the investor should choose a fund which has a lower expense ratio compared to other funds provided the returns are consistent.

## 5. What approaches does the fund manager use to build portfolios?

A fund manager uses different technical and fundamental parameters of a stock before making it a part of his portfolio. Therefore, while building their portfolio, the manager can follow any of the two processes given ahead.







## Top-Down Approach

In this approach, the manager starts by studying the macroeconomic scenario from a global and domestic point-of-view.

After this, he analyses the different sectors of the economy to choose the ones which can perform well in the prevailing economic scenario.

For example, if interest rates are bound to fall, the real estate sector will benefit from this, and the manager will choose these stocks to invest in.



## Bottom-Up Approach

In this approach, the manager does the above process in reverse.

He first selects the companies he wants to invest in.

Then he evaluates how the company will perform under the present economic scenario by testing different scenarios on it.

## 6. How can a customer invest in a mutual fund?

Mutual funds allow investment in two ways -

### 1) Lump sum

The most basic way to invest in a mutual fund is to do a one-time investment through a lump sum amount and let it grow with time.

### 2) Systematic Investment Plan (SIP)

This method was built for people who prefer periodic investment rather than a big one-time payment. Through an SIP, a person can invest for a minimum of even ₹500 per month in a mutual fund. It is an ideal option for salaried persons.

### An SIP gives the investor the benefits of market fluctuations. How?

When you will invest a fixed amount monthly, you will receive different units of the mutual fund every month due to changes in the NAV. You will not have to spend more on the same amounts of units because of a rise in the NAV, which is a big advantage of choosing an SIP.

This benefit is known as **rupee cost averaging**.



## 7. How can a customer redeem their investment?

Like investing, redemption can also be done either in one go or in installments. In case of installments, it is known as **systematic withdrawal plan**.

A customer can give the request to redeem a certain part of the portfolio on a specified date of the month.

Similar to an SIP, the customer benefits from market fluctuation since the NAV on the withdrawal date of different months will be different.

## 8. What are the fundamental attributes of a mutual fund scheme?

The fundamental attributes of a mutual fund scheme are its basic features that can affect one's decision to stay invested in a scheme or make fresh investments in a scheme.

Examples of Fundamental attributes are:

- 1. Type of a scheme** (change of scheme from equity to debt or change in investment allocation pattern defined in the offer document.)
- 2. Investment Objective**
- 3. Liquidity terms** (change in lock-in period / exit load)
- 4. Merger of a scheme with another scheme within a single AMC**
- 5. Buyout of one AMC by another**



For any change in fundamental attributes, SEBI approval is required, but investor approval is not needed.

However, each investor must be informed through communication like email / letter and given the option to exit without any exit load within a fix period of time.



# Key Learning Points

- A mutual fund is a pool of money from different investors who neither have the time nor the knowledge to invest in the stock market.
- A fund manager is an experienced individual who manages the fund on the behalf of a mutual fund company.
- The advantages of mutual funds include the opportunity of diversification, professional fund management, etc.
- When an investor invests in a mutual fund, he/she buys Units at the prevailing market price which is called NAV or the Net Asset Value.
- Investment in a mutual fund can be done either as a lump sum or at regular intervals which are known as a systematic investment plan.
- Similarly, withdrawal from a mutual fund scheme can either be done as a lump sum or as a systematic withdrawal plan.
- Fundamental attributes of a mutual fund scheme are its basic features that can affect one's decision to stay invested in a scheme.





# Multiple Choice Questions



**1. Mutual fund is a pool of money from different investors managed by which specialist?**

- a. Economist
- b. Banker
- c. Fund Manager
- d. Professor

**2. Where does a mutual fund manager invests the investor's money?**

- a. Equities
- b. Debt
- c. Both the above
- d. None of the above

**3. Why would an investor want to invest in a mutual fund?**

- a. To earn higher returns than traditional investment products
- b. To have better liquidity
- c. To have a diversified portfolio of funds
- d. All of the above

**4. How does mutual fund investment work?**

- a. At maturity or when a need arises, he withdraws the money by selling the units.
- b. They receive units of the mutual fund scheme
- c. The investors invest money through SIP or in lumpsum
- d. Investors get KYC done and registers to invest in a mutual fund scheme



**5. Arrange the above events in sequence of their occurrence**

- a. A-B-C-D
- b. D-C-B-A
- c. D-C-A-B
- d. A-B-D-C

**6.. NAV stands for Net Assets Value. It is the total market value of the securities held by the fund less the value of its liabilities.**

- a. The above statement is:
- b. False
- c. True
- d. Can't say
- e. Information not enough

**7. What are the modes of investment in a mutual fund?**

- a. Systematic Investment Plan (SIP)
- b. Lumpsum
- c. None of the above
- d. Both the above

**8. How can an investor redeem a fund?**

- a. All at once (lumpsum)
- b. In Installments (Systematic Withdrawal Plan)
- c. Both the above
- d. None of the above



## Chapter 2: Types of mutual fund



In this chapter, we discuss the major changes that were brought by SEBI via a circular on “Categorization and Rationalization of Mutual Fund Schemes” dated October 6, 2017. The basic idea behind this circular was to ease the process of investment in mutual fund by the investors.



# 1. Categories of Mutual Funds in India

The Indian mutual fund industry offers many types of mutual fund schemes, and this circular helps us to understand these types better.

SEBI has defined the following broad categories -

1. **Equity Mutual Funds** (invest predominantly in equity)
2. **Debt Mutual Funds** (invest predominantly in debt)
3. **Hybrid Mutual Funds** (combinations of asset classes)
4. **Solution-Oriented Mutual Funds** (built to provide a solution for customer)
5. **Other Mutual Funds.**

Each of the categories is further classified on the basis of type of scheme; and minimum investment the scheme should have in equity and equity related assets.

## 2. The Basics of Re-Categorization of the Mutual Fund schemes in India

Before we understand each of the categories briefly, let us understand some important points from the circular.

### **Q. What are the different types of schemes available in mutual funds?**

Mutual funds schemes can be of two types - open-ended and closed-ended.

**Open-ended schemes** are those from which an investor can enter and exit anytime they like. They are highly liquid in nature, and are not traded in the stock market. These mutual funds are available for purchase only through the Asset Management Company that prepares the mutual fund.

**Closed-ended schemes** are those which have a fixed number of units, and have restrictions on entry into the fund.



## Q. What are the different types of schemes available in mutual funds?

The market capitalization of a company is the total market value of all its shares being traded in the stock market.

There are three types of mutual fund categories built on the basis of market capitalization -

### Large Cap Mutual Funds

The schemes comprising of the first 100 companies ranked on the basis of market capitalization are large cap funds.

### Mid Cap Mutual Funds

The schemes comprising of the companies ranked 101st - 250th on the basis of market capitalization are mid cap funds.

### Small Cap Mutual Funds

The schemes comprising of the companies ranked below the 250th company on the basis of market capitalization are small cap funds.

For selecting the companies for building these categories, mutual funds shall follow the list uploaded by the Association of Mutual Funds in India (AMFI).

This list shall be updated every six months, on 30 th June and 31 st December every year.

Post the updating of the stock list by AMFI, mutual funds will be required to readjust the existing portfolios as per the updated list of stocks on the AMFI website.

Only one scheme per category of mutual fund shall be permissible except:

- Index funds
- ETFs
- Fund of funds
- Sectoral/thematic funds

This means that a scheme of one category (large, mid or small cap) can either be **open-ended** or **closed-ended**. For example, no Asset Management Company can hold two large cap mutual fund schemes, with one of each scheme type.

Now let us study each category of scheme separately.





# *Types* of Mutual Fund in India

## I. EQUITY MUTUAL FUNDS

### 1. Multi Cap Fund

This scheme is open-ended and invests across combinations of large cap, mid cap and small cap stocks.

Minimum 65% of its total assets should be invested in equity and equity-related instruments.

### 2. Large Cap Fund

This scheme is open-ended and majorly invests in large cap stocks.

Minimum 80% of its total assets should be invested in equity and equity-related instruments of large cap companies.

### 3. Large & Mid Cap Fund

This scheme is open-ended and invests in both large and mid cap stocks.

Minimum 35% of its total assets should be invested in the equity and equity- related instruments of mid cap companies, and minimum 35% of its total assets should be invested in the equity and equity-related instruments of large cap companies.

### 4. Mid Cap Fund

This scheme is open-ended and invests in mid cap stocks.

Minimum 65% of its total assets should be invested in the equity and equity- related instruments of mid cap companies



## 5. Small Cap Fund

This scheme is open-ended and invests in small cap stocks.

Minimum 65% of its total assets should be invested in the equity and equity-related instruments of small cap companies

## 6.Dividend Yield Fund

This scheme is open-ended and invests predominantly in dividend yielding stocks.

Minimum 65% of its total assets should be invested in equity.

## 7. Value Fund

This scheme is open-ended and it follows a value investment strategy.

This means that the fund focuses on three types of stocks -

- i. Under-performing stocks;
- ii. Stocks with a low P/E ratio (Price-to-Earnings ratio); and/or
- iii. Stocks of companies of emerging sectors, which show potential for rapid growth in the future.

Minimum 65% of its total assets should be invested in equity and equity-related instruments.

## 8.Contra Fund

This scheme is open-ended and it follows a contrarian investment strategy.

This means that the fund invests against the ongoing market trends.

Minimum 65% of its total assets should be invested in equity and equity-related instruments.

A mutual fund can either be a value fund or a contra fund. It cannot follow both strategies at the same time.



## 9. Focused Fund

This scheme is open-ended and invests in a maximum of 30 stocks while focusing on a certain level of market capitalization.

Minimum 65% of its total assets should be invested in equity and equity-related instruments.

## 10. Sectoral/Thematic Fund

This scheme is open-ended and invests in a particular sector or defines a theme around which its investments revolve.

Minimum 80% of its total assets should be invested in the equity and equity-related instruments of the selected theme or sector by a particular mutual fund.

## 11. Equity Linked Savings Scheme (ELSS)

This scheme is open-ended, with a statutory lock-in period of three years and tax benefits under section 80C of the Income Tax Act, 1961.

In accordance with the Equity Linked Saving Scheme, 2005, as notified by Ministry of Finance, minimum 80% of its total assets should be invested in equity and equity-related instruments.

# II. DEBT MUTUAL FUNDS

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## 1. Overnight Funds

This is an open-ended scheme that invests in fixed income securities with a maturity of one day.

## 2. Liquid Funds

This is an open-ended scheme that invests in debt and money market instruments with a maturity of up to 91 days.



### **3. Ultra Short Duration Fund**

This is an open-ended scheme which invests in debt and money market instruments

The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be from 3 to 6 months

### **4. Low Duration Fund**

This is an open-ended fund which invests in money market and debt instruments.

The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be more than 7 years..

### **5. Money Market Fund**

This is an open-ended scheme which invests in money market instruments with a maturity of up to one year.

### **6. Short Duration Fund**

This is an open-ended fund which invests in money market and debt instruments. The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be between 1 to 3 years.

### **7. Medium Duration Fund**

This is an open-ended fund which invests in money market and debt instruments. The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be between 3 to 4 years.

### **8. Medium to Long Duration Fund**

This is an open-ended fund which invests in money market and debt instruments. The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be between 3 to 4 years.

### **9. Long Duration Fund**

This is an open-ended fund which invests in money market and debt instruments. The Macaulay duration (weighted average term to maturity of the cash flows from a bond) of the portfolio should be more than 7 years.



## 10. Dynamic Bond Fund

This is an open-ended dynamic debt fund scheme. This scheme invests across different types of duration funds, which have been discussed previously.

## 11. Corporate Bond Fund

This is an open-ended scheme that predominantly invests in highly-rated corporate bonds. Minimum 80% of its total assets should be invested in only the highest rated corporate bonds.

## 12. Credit Risk Fund

This is an open-ended scheme that invests in those bonds which are ranked below the highest-rated corporate bonds. Minimum 65% of its total assets should be invested in such corporate bonds, which are rated below the highest-ranking bonds.

## 13. Banking and PSU Fund

This is an open-ended scheme that invests in the debt instruments of banks, PSUs (Public Sector Undertakings) and Public Financial Institutes. Minimum 80% of its total assets should be invested in the debt instruments of the above-mentioned types of organizations.

## 14. Gilt Fund

This is an open-ended scheme which invests in government securities across different duration types. Minimum 80% of its total assets should be invested in government securities.

## 15. Gilt Funds with 10-year constant duration

This is an open-ended debt scheme which invests in government debt securities with a constant maturity of ten years. Minimum 80% of its total assets should be invested in government securities with a Macaulay duration (weighted average term to maturity of the cash flows from a bond) of ten years.



## 16. Floater Funds

This is an open-ended scheme which predominantly invests in floating rate instruments.

A floating rate indicates that the interest rate offered by the debt instrument doesn't offer a fixed rate of interest over the life of the debt instrument. Minimum 65% of its total assets should be invested in floating rate debt instruments

## III. HYBRID FUNDS

### 1. Conservative Hybrid Funds

This is an open-ended hybrid scheme that invests predominantly in debt instruments. The investment in debt and debt-related instruments should be between 75% to 90% of the total assets whereas the investment in equity and equity-related instruments should be between 10% to 25%.

### 2. Balanced Hybrid Funds

This is an open-ended hybrid mutual fund scheme which has balanced investments between debt and equity. The investment in debt and debt-related instruments should be either 40% or 60% of the total assets whereas the investment in equity and equity-related instruments should be either 60% or 40% of the total assets. No arbitrage is permitted in this scheme.

### 3. Aggressive Hybrid Funds

This is an open-ended scheme that focuses more on equity investments. The investment in debt and debt-related instruments should be between 20% to 35% of the total assets whereas the investments in equity and equity-related instruments should be between 65% to 80% of the total assets.

**Mutual funds will be permitted to offer either an aggressive or a balanced fund.**

### 4. Dynamic Asset Allocation or Balance Advantage Fund

This scheme is an open-ended dynamic asset allocation fund.

This means that the scheme adjusts its investments frequently to suit the ongoing market conditions.



## 5. Multi Asset Allocation Fund

This scheme is open-ended and it focuses on investing in different types of asset classes.

The scheme should invest in at least three asset classes and minimum 10% of its total investments should be invested in each asset class separately.

**Foreign securities will not be treated as a separate asset class.**

## 6. Arbitrage Fund

This is an open-ended scheme that focuses on arbitrage opportunities. This means that the scheme profits from the differences in prices between the stock and the derivatives market to generate returns.

Minimum 65% of its total assets should be invested in equity and equity-related instruments.

## 7. Equity Savings Fund

This is an open-ended scheme that invests in debt, equity and arbitrage opportunities. The minimum hedged and unhedged portion is to be stated in the Scheme Information Document.

Minimum 65% of its total assets should be invested in equity and equity-related instruments whereas minimum 10% of its total assets should be invested in debt and debt-related instruments.

# IV. SOLUTION ORIENTED SCHEMES

## 1. Children's Fund

This scheme is an open-ended fund for investment, for children having a lock-in for at least 5 years or till the child attains age of majority (whichever is earlier).

## 2. Retirement Fund

This scheme is an open-ended fund which is retirement-solution oriented, having a lock-in for at least 5 years or the retirement age (whichever is earlier).





# V. OTHER SCHEMES

## 1. Index Funds or ETFs

Also known as Exchange Traded Funds or ETFs, an Index Fund shows investments in the securities of a particular index which is being tracked or replicated. Minimum 95% of its total assets should be in line with the particular index chosen. For example, if a person wishes to buy gold, he can either do it physically in a shop or he can do it online in the form of an ETF.

## 2. Fund of Funds (FoFs) (overseas/Domestic)

This fund invests in the units of other mutual funds instead of investing in the stocks directly. Minimum 95% of its total assets should be in the underlying mutual fund units.

## 3. Benefits of Re-Categorization

This re-categorization has many advantages for the investors. These include -

1. Ease in comparing mutual fund schemes offered by different asset management companies.
2. Enhanced transparency to ensure that investors align their financial goals and make right investment decisions.
3. Increased simplification for investors to understand the nature of investments and risk exposure in schemes.

## Key Learning Points:

1. Categories of mutual fund schemes are equity, debt, hybrid, solution oriented and others.
2. Stocks are classified on the basis of market capitalization into large cap, mid cap and small cap.
3. First 100 companies with highest market capitalization are the large companies, next 250 companies fall into mid cap and the rest falls into small cap companies.
4. Purpose of categorization is to make it easier for investors to compare and select funds among many schemes available.



# Multiple Choice Questions



**1. The categories of mutual fund schemes are:**

- a. Equity & Debt
- b. Hybrid
- c. Solution-Oriented
- d. All of the above

**2. Based on market capitalization, how are the stocks classified?**

- a. Big, medium and small companies
- b. Large cap, mid cap and small cap companies
- c. Large cap and small cap companies
- d. No such classification is done

**3. What do you mean by open-ended schemes?**

- a. It allows investors to invest money and withdraw at all times.
- b. It doesn't allow investors to invest and withdraw at all times.
- c. It allows investors to invest and withdraw subject to some conditions.
- d. Open-ended schemes are not available in mutual funds.

**4. What minimum equity investment is a must for equity large cap fund?**

- a. 65% of total funds should be in large cap equity
- b. 80% of total funds should be in large cap equity
- c. 35% of total funds should be in large cap equity
- d. 100% of total funds should be in large cap equity

**5. What is the maximum no. of stocks, a focused fund can hold at a given point of time?**

- a. 30
- b. 35
- c. 20
- d. No limit



**6. Which among the following is not a sub-category of Equity Fund?**

- a. Multi-cap
- b. ELSS
- c. Focused Fund
- d. Gilt Fund

**7. Which among the following is not a sub-category of Debt Fund?**

- a. Floater Fund
- b. Liquid Fund
- c. Arbitrage Fund
- d. Money Market Fund



## Chapter 3: NFO and Offer Documents



In this chapter, we will cover the basics of the New fund Offer and the Offer Document of a mutual fund scheme. We will also talk about the types of risk factors involved in the investment of a mutual fund for investors.



# 1. What is an NFO (New Fund Offer) and how does it work?

Just like a public company offers its shares to the public via an Initial public offering (IPO), an Asset Management Company (AMC) offers units of the mutual fund to the public via a **New Fund Offer (NFO)** in the stock market.

The NFO is a process which attempts to raise capital to purchase securities for the mutual fund scheme.

The AMC prepares **Offer Document** (prospectus) for the NFO, and after getting permission from SEBI, decides a suitable time for launch in the market.

There are 3 relevant dates related to NFO -

## **Opening Date**

It refers to the date on which the fund opens for subscription to the public.

## **Closing Date**

It refers to the date on which the fund closes for subscription to the public.

## **Subscription Reopening Date**

After the NFO is over, the scheme will be open for entry and exit as it will now be a listed fund. The date at which the fund becomes available for trading in the stock market is the subscription reopening date.

# 2. What is Offer Document (OD) and what is its importance?

Similar to the prospectus of a newly listed company, the Offer Document is the most important source of information about mutual fund scheme for investors. It is a legal document and it describes the product and all the important aspects surrounding its management and maintenance. The OD discloses the following components -

- The names and background of fund managers;
- Details of the investor relation officer;
- Details of the AMC and its directors;
- Details of the custodian and the registrar;
- Details of the transfer agent; and
- Details of the statutory auditor.





A mutual fund's offer document is divided into 2 parts -

#### **Scheme information document (SID)**

This document comprises the details of one specific mutual fund scheme.

#### **Statement of additional information (SAI)**

The SAI deals with statutory information for all the schemes of the Asset Management Company which is offering the scheme.

## **3. What is KIM (Key Information memorandum)?**

KIM is a summarized version of the Offer Document (OD). As per SEBI regulations, every application form is to be accompanied by the KIM.

The first time investor should read detailed offer document, once he has gained familiarity with the AMC, he can just refer to KIM.

## **4. Risk Factors in Mutual Fund Schemes**

In a mutual fund scheme, an investor has to understand the various elements of their investment which are susceptible to risk.

Such elements are known as risk factors, and there are two types of risk factors in a mutual fund -

**Standard risk factors;**  
**Scheme specific risk factors.**

## **5. What are Standard Risk Factors?**

Standard risk factors are same (common) for all the MF Schemes. These factors are inherent to investing in the markets and have to be faced by investor.





## 6. Examples of Standard Risk Factors

The basic examples of such factors are included in some statements which are issued by AMCs in their advertisements of mutual fund schemes.

Some of these statements include -

- Investment in mutual fund units involves investment risks such as trading volumes, settlement risks, liquidity risk, default risk including the possible loss of principal.
- As the price, value, interest rates of the securities in which the scheme invests fluctuate, the value of the investment may go up or down.
- Mutual funds are subject to market risks and there is no guarantee that the Fund's objective will be achieved.
- Past performance is not a guarantee of future performance.
- The name of the scheme does not indicate either the quality or its future prospects and returns



## 7. What are Scheme Specific Risk Factors?

These risks are specific to a scheme, i.e; they do not apply to all mutual fund schemes.

Examples of scheme specific risks are:

- The risk arising from the investment objective of the scheme;
- The risk arising from the investment strategy of the scheme;
- The risk arising from the asset allocation of the scheme; and
- The risk arising from any non-diversification in the scheme.



# Key Learning Points

1. New Fund Offer is an event in which a new mutual fund scheme offers its units to investors for the first time.
2. Offer Document is the operating document and describes the product.
3. Key Information Memorandum (KIM) is a summarized version of the Offer Document. Every application form is to be accompanied by the KIM.
4. Standard risk factors are inherent to investing in the markets and have to be faced by investors.
5. Scheme Specific Risk factors are risk arising from investment objective, investment strategy, asset allocation of the scheme, non – diversification.





# Multiple Choice Questions



**1. New Fund Offer initiates the issue of?**

- a. Shares
- b. debentures
- c. mutual fund
- d. none of the above

**2. Which among these are important dates in a new fund offer?**

- a. Opening date
- b. Closing date
- c. Scheme re-opening date
- d. All of the above

**3. \_\_\_\_\_ is a summarized version of the Offer Document.**

- a. Key Information Memorandum
- b. Summarized Offer Document
- c. Key Memorandum
- None of the above

**4. Which document discloses the names and background of fund managers, key personnel, investor relation officer, AMC and its directors, custodian, registrar, transfer agent and the statutory auditor?**

- a. Prospectus
- b. Offer Document
- c. Official announcement
- d. d.Key Information memorandm



**5. Which part of the offer document contains information about the particular scheme that is introduced?**

- a. Scheme Information Document (SID)
- b. Statement of Additional Information (SAI)
- c. Both a and b.
- d. None of the above

**6. Who bears the initial issue expenses?**

- a. fund houses
- b. regulators
- c. investors
- d. brokers

**7. Investment in mutual fund units involves investment risks such as trading volumes, settlement risks, liquidity risk, default risk including the possible loss of principal. Which risk factors are these?**

- a. Scheme specific risk factors
- b. Standard risk factors
- c. General risk factors
- d. Default risk factors

**8. Risk arising from investment objective, investment strategy, asset allocation of the scheme, non –diversification is known as-**

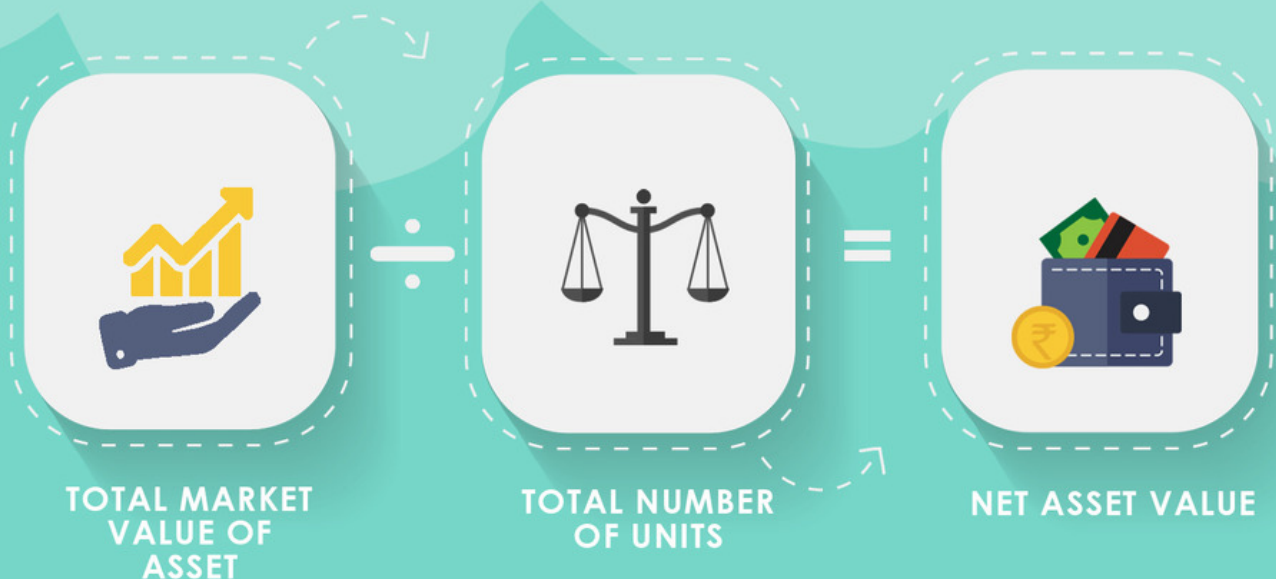
- a. Scheme specific risk factors
- b. Standard risk factors
- c. General risk factors
- d. Default risk factors



# Chapter 4: Net Asset Value & the Accounting and Taxation of Mutual Funds

## NET ASSET VALUE

#PTICINDIA



This chapter will make you understand the meaning and the calculation of the Net Asset Value (NAV) of a mutual fund and the valuation of each security in the scheme and the dividends of a mutual fund unit. We will also discuss the various taxes and charges on the gains investors receive from their mutual fund investments.



# 1. What is a Net asset value (NAV)?

NAV is the amount receivable by the investor or mutual fund unit holder in case the mutual fund is wound up.

For understanding this concept, remember the following three trigger points in mind:

For understanding this concept, keep the following points in mind -

- The NAV of a mutual fund shows the **market value of the fund's assets** reduced by the **liabilities attributable to those assets**.
- The NAV changes everyday.
- The NAV of a mutual fund is calculated unit-wise, not as per all the units together.

## 2. How is NAV of a mutual fund calculated?

The formula for calculating NAV of the mutual fund is:

**NAV = Net assets of the scheme / Number of units outstanding**

The NAV of a fund is calculated by either

- The mutual fund house itself; or
- By a SEBI-authorized NAV accounting firm chosen by the mutual fund.



## 3. What are net assets of a mutual fund and how are they valued?

The net assets of a mutual fund include all the resources that have been invested into the stocks of the mutual fund scheme.

The Net Assets of a mutual fund are calculated as given ahead:



Market value of investments made	XXX
Add: Receivables	XX
: Other Accrued income	XX
: Other assets	XX
Less: Accrued expenses	(XX)
: Other liabilities & <u>payables</u>	(XX)
Net Assets Value	XXX

Given below are some common examples of net assets and their valuation rules -

- **Listed and traded securities** should be valued on the closing market value.
- **Illiquid shares and debentures** should be valued at the lower of either the book value or the last available price.
- **Listed/Traded debentures** and bonds should be valued at the lower of either the **closing traded value or the yield value**.
- **Fixed income securities** should be valued at their current yield.

## 4. How frequently is the NAV calculated?

The NAV of every fund is calculated at the end of every market day (business day), on the basis of the closing market prices of the securities that the fund or scheme is invested in.

Any changes in the NAV indicate a rise or a dip in the prices of assets of the mutual fund scheme.

## 5. How does a mutual fund scheme calculate the reserve for declaring dividends?

A mutual fund scheme follows the following SEBI guidelines for calculating the reserve-



- All profit earned (including accrual income) are available for distribution.
- Valuation gains are ignored but valuation losses needs to be adjusted against profit.
- Mutual funds declare dividends only when there is a surplus which can be distributed. They are a reflection of distribution of profits and gains.

For example, suppose an investor buys a fund at a NAV of ₹14.

Here, ₹10 will go into capital account since the face value is ₹10.

The balance of ₹4 will go as premium reserve. If the invested amount of ₹14 grows up to ₹17, then the fund can declare a dividend of ₹3, which is the gain on the NAV of ₹14.

The funds cannot use the unit premium reserve to pay its dividends.

## 6. What is MTM (Mark to Market) and its importance?

The process of valuing each security in the investment portfolio of the scheme at its market value is called "MARK TO MARKET" in mutual fund parlance.

This process is very important for mutual fund investors to understand for the following reasons -

- MTM helps in finding the asset values according to the market prices at the end of each day in order to arrive at the profit or loss status of the parties.
- MTM helps investor buy & sell units of a scheme at a true and fair price.
- Mark to market based NAV helps in assessing the performance of the scheme / Fund manager.





## 7. What kind of expenses can be charged to mutual fund scheme and up to what extent?

There are two important charges one should be aware of while investing in a mutual fund - the expense ratio and the exit load. Both of these are discussed below.

### 1. Total Expense Ratio

Asset Management Companies manage the assets of mutual funds and take the investment decision. For this, they charge many different expenses. Some examples of these include -

- i. Office rentals;
- ii. Employee salaries;
- iii. Legal and audit fees;
- iv. Software charges; and
- v. Distributor commission, etc..

All these expenses are together termed as the Total Expense Ratio.

The TER tends to fall as the AUM (Assets Under Management) increases. The SEBI has placed limits on the maximum expense ratio that can be charge to investors. The limits are given as below:

AUM Slab	Expense Ratio
0-500 crores	2.25%
500-750 crores	2%
750-2000 crores	1.75%
2000-5000 crores	1.6%
5000-10000 crores	1.5%
10000-50000 crores	TER reduction of 0.05% for every increase of Rs 5000 crores AUM or part thereof
>50000 crores	1.05%

### 2. Exit Load

The exit load is a fee which is levied on an investor when he exits or leaves a scheme before the stipulated period.



Exit load, unlike an expense ratio, is not charged by all mutual fund schemes.

It is simply a pre-exit penalty to discourage investors from withdrawing their funds too early from a mutual fund.

## 8. What is Dividend Distribution Tax (DDT) and when is it levied?

This is a tax on dividend distributed by both equity & debt-oriented mutual fund schemes. This tax is deducted at source by the AMC before distributing the dividend to unit-holder's bank account. The dividend amount so received is exempt from tax in the hands of the investor.

Surcharge and cess are also calculated separately on the tax rate.

Type of Scheme (only in dividend option)	Rates for Resident Individual / HUF
Equity Oriented Scheme	10 % + 12 % Surcharge + 4 % Cess = 11.60%
Debt Oriented Schemes	25 % + 12% Surcharge + 4 % Cess = 29.00 %

## 9. What is Securities Transaction Tax (STT) and when is it levied?

This is a tax on the value of transactions in equity shares, derivatives and ETFs / equity mutual fund units. STT is not payable on transactions in debt or debt-oriented mutual fund units. But it is applicable when you switch out to a different mutual fund scheme.

STT was introduced in 2004 by the then Finance Minister in 2004 to stop tax avoidance of capital gains tax.

Rates of Securities Transaction Tax (STT)	
Equity shares / MF / ETF on buy and sell (delivery based transaction)	0.10 %
Equity shares / MF / ETF on buy and sell (non-delivery based transaction)	0.025%
Equity MF purchase from AMC	NIL
Equity MF /ETF Sale (Repurchase)by AMC	0.001%



## 10. What is capital gains tax?

Any profit or gain which comes from the sale of a capital asset is known as capital gain.

This gain or profit is considered as income and hence charged to tax in the year in which the transfer of capital asset takes place.

This is called capital gains tax which can be short term or long term depending upon the period of holding the investments.

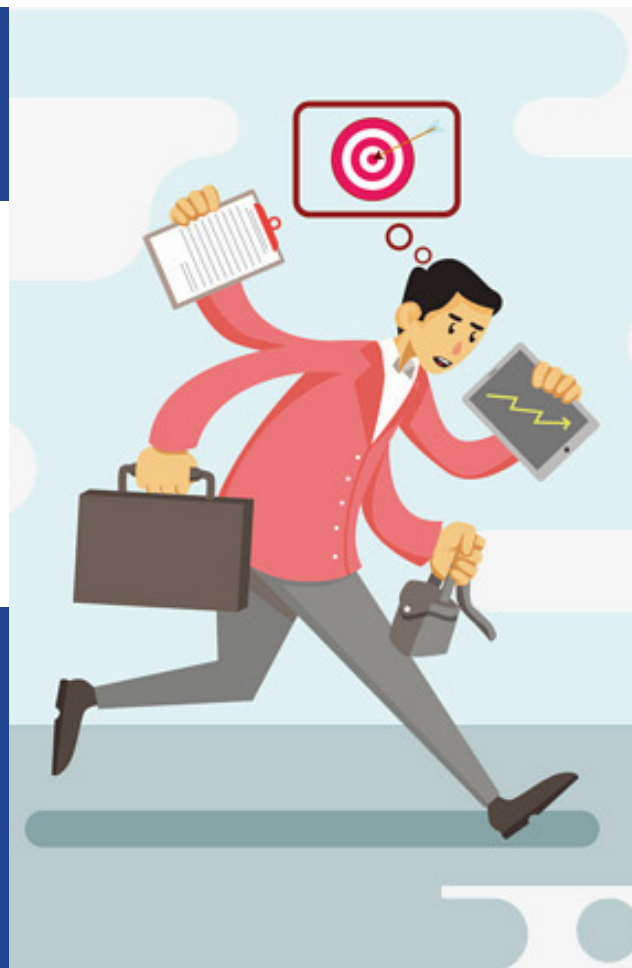
## 11. What is the rate at which capital gains tax is levied on investors?

If a mutual fund unit is held for less than 1 year, short term capital gains tax is levied @15%.

If the units are held for more than a year then no tax is levied up to Rs 100000.

Greater than Rs 100000, it is 10% on the amount above Rs 1 lakh.

## 12. How to calculate Short term and Long Term Capital Gains Tax on mutual funds (as per Budget 2018)?



Short-Term Capital Gains tax is levied at 15%.

Prior to the Budget 2018, Long-Term Capital Gains were tax-free in the hands of the investor. But now, any gains exceeding Rs. 1,00,000 and held for more than 12 months is taxable at 10%.

Actual method for calculation of long term capital gains tax is to be done as per the special formula proposed in the Budget 2018.

Long term capital gains tax can also be reduced by the technique of indexation, as discussed next.



## 13. What is indexation?

Indexation is defined as adjusting the purchase price of your asset (your investment) to reflect the impact of inflation and the capital gains are taxed accordingly. Purpose is to enable you to pay lower tax by using indexation facility.

### Calculation of Indexation

To reduce the taxes payable on your capital gains are the following numbers: -

- Cost Inflation Index (CII). This is released every year by income tax department
- The value of your original investments
- The value of your existing investments

Once you have all these numbers, you will need a simple equation to calculate your indexed capital gains. The equation is expressed like this:

$$\text{Amount Invested} \times (\text{CII for year of Sale} / \text{CII for year of purchase}) = \text{'Indexed cost'}$$

Let us understand how this formula works through an example.

Suppose you invest ₹1,00,000 in a mutual fund in 2015, and in 2018, you decide to withdraw your investment by selling off your mutual fund units. The following table shows us how the indexed costs reduce our tax liability -

Investment details in a debt oriented mutual fund	Amount (₹)
Original Investment	100000
Redemption Value	115000
Cost Inflation Index	
CII- for the year of purchase (2015 – 16)	254
CII- for the year of Sale ( 2018 – 19)	280
Indexed Cost of Original Investment (CII for year of Sale/CII for year of purchase) * Original cost of purchase	110236
Capital Gains	
With compulsory indexation (₹115000- ₹110236)	4764
Without indexation (₹115000 – ₹100000)	15000
Tax on Long Term Capital Gains	
With indexation (₹4764 * 20%) (this is a compulsory option to be taken)	953
# Without indexation @ 30 % ( ₹15000 * 30%) (this is no more an option)	4500



# Assumed that investor falls in highest tax bracket of 30 %

Factoring in indexation can help the investor reduce his tax liability. He will pay max rate of income tax if he does not use the indexation facility. Point to be noted is that here that timing your investments is crucial to make this method work effectively for saving your taxes ,i.e., your investment should cross 3 financial years.

### Applicability of Indexation

Indexation facility can be availed by you only if your investment in a debt oriented mutual fund is for more than 3 years from the date of investment. Holding period lower than 3 years will attract applicable tax rate wherein indexation facility is not available

## Key Learning Points

1. NAV is the market value of the assets reduced by the liabilities attributable to those assets.
2. NAV is calculated at the end of every market day (business day), on the basis of the closing market prices of the securities that the fund or scheme is invested in.
3. Daily changes in NAV It indicate a rise or dip in the prices of assets of the mutual fund scheme.
4. The process of valuing each security in the investment portfolio of the scheme at its market value is called "MARK TO MARKET" in mutual fund parlance.
5. Expense ratio is the percent of invested funds charged as fee by the asset management companies.
6. DDT is a tax on dividend distributed by both equity & debt-oriented mutual fund schemes.
7. STT is a tax on the value of transactions in equity shares, derivatives and ETFs / equity mutual fund units.
8. Capital Gain Tax is charged on the gains made on sale of mutual fund.
9. Indexation is defined as adjusting the purchase price of your asset (your investment) to reflect the impact of inflation and the capital gains are taxed accordingly.



# Multiple Choice Questions



## 1. NAV is

- a. Book Value of net assets held by a mutual fund scheme
- b. Market Value of net assets held by a mutual fund scheme
- c. Net Annual Value at the end of a year
- d. Value of new investment made every year

## 2. To calculate the NAV which value of listed and traded equity shares is considered?

- a. Book Value
- b. Lower of book value or last available price
- c. Closing Market Price
- d. Market Price at the beginning of the year.

## 3. NAV is calculated

- a. at the end of every month
- b. at the end of every week
- c. at the end of every year
- d. at the end of every business day

## 4. Daily changes in NAV indicates a rise or dip in the prices of assets of the mutual fund scheme

- a. False
- b. True
- c. Can't say
- d. Cannot be determined

## 5. The process of valuing each security in the investment portfolio of the scheme at its market value is called

- a. at market price
- b. market valuation
- c. mark to market pricing



**6. On which of the following transactions, STT is not levied**

- a. equity shares
- b. derivatives
- c. ETFs / equity mutual fund units
- d. debentures

**7. Rate at which short term capital gain is taxed on sale of mutual fund units**

- a. 5%
- b. 10%
- c. 15%
- d. 20%

**8. Long term capital gains made on sale of mutual fund units is taxed at 10% after an exemption up to Rs. 250000.**

- a. True
- b. False



# Chapter 5 : Risk, Return and Performance of Funds



In this chapter, we will discuss the types of risks associated with mutual funds, and the factors affecting the returns of an investment in mutual funds. We will also discuss about how the performance of a mutual fund is measured.



# 1.What are the types of risks involved in a Mutual Fund?

Risk is defined as the probability or threat of losses in trading.

The following types of risks are prevalent in our investments in the different types of mutual fund schemes -

## **Interest rate risk**

The risk of the value of fixed-income securities going down due to a rise in the interest rates is known as the interest rate risk.

## **Inflation risk**

The risk that an investor faces due to inflation. When prices rise due to inflation, we lose our purchasing power. This risk of losing our purchasing power is inflation risk

## **Credit risk**

The risk that the issuer of the securities which form a part of the mutual fund you have invested in, won't have enough money to redeem your investment when the time comes.

## **Volatility Risk**

The risk of losses due to the changes of prices of securities due to the change in the volatility of the market instruments. Market volatility indicates the degree of change of the price of an instrument being traded on the market.

## **Concentration risk**

The risk of making losses due to the concentration of the mutual fund investments on one segment of the market, and it ends up making losses.

For example, suppose you invest in a scheme that invests in equity heavily. Therefore, if the companies of the equity segment makes losses, your overall portfolio would suffer. Therefore, you are at a risk of loss due to the concentration of a scheme on one segment of the market, and that's concentration risk.

## **Liquidity risk**

The risk of not being able to liquidate your investments due to the lack of buyers in the market or due to a lock-in period on the scheme. The lack of buyers would mean that you can't rid yourselves of your mutual fund units. A lock-in period is the minimum amount of time for which you must hold the units of a mutual fund.

If you exit before the lock-in period, your gains will be subject to a charge called the exit load. It is not necessary that all these types of risks are present in every type of mutual fund.

Let us discuss the different risks involved in the different popular categories of mutual funds.



## 2. Types of risks in popular mutual fund schemes

### Equity Mutual Funds

These mutual funds predominantly invest in equity stocks, and are prone to the following risks -

- Performance risk;
- Concentration risk; and
- Volatility risk.

### Debt Mutual Funds

These schemes predominantly invest in debt and are prone to the following risks-

- Interest rate risk; and
- Credit risk.

### Gold Mutual Funds

These schemes are either mutual funds or Exchange Traded Funds (ETFs) which concentrate their investments in gold-producing stocks. These schemes are prone to the following risks -

- Inflation risk; and
- Volatility risk.

### Real Estate Funds

These funds comprise of stocks which are issued by companies who use the money to invest in real estate assets. The funds are exposed to the following types of risks -

- Liquidity Risk;
- Interest rate risk; and
- Volatility risk.

## 3. How do we measure the risks involved in a mutual fund?

Given below are some of the popular methods used to measure the risks involved in mutual funds -

### Alpha

This is a quantitative measure of the risk of the scheme portfolio in comparison to the market in general or a certain index.

### Beta

This is a quantitative measure of the systematic risk in a portfolio, which can be reduced through diversification.

### Standard Deviation

This measures the scattering or the dispersion of the data from its mean. The higher the standard deviation, the more volatile the stock's performance will be.





## 4. Which factors affect the returns in a mutual fund scheme?

A mutual fund is a bundle of securities created to earn returns. These returns, however, are not just dependent on the right equity-debt mix, but also on some other other important factors, as discussed below -

### Market Volatility

The degree of change in the prices of the securities that make up the mutual fund is the prime deciding factor in the level of returns an investment can generate. The more volatile the market is, the harder it is to estimate returns at a given point of time.

### Industry Performance

The returns of a scheme also depend on the profits of the underlying industry or sector. If the sector on which the scheme concentrates on does not perform well in the market, the whole mutual fund portfolio will suffer.

### Fees and expenses

The fees, expenses and taxes that are charged to the profits can also affect the final gains that we receive from the sale of our investment. The higher the percentage of such fees and expenses, the lower will be the returns.

## 5. How do we measure the returns from a mutual fund scheme?

The following methods are used to measure the returns of a mutual fund investment -

### Absolute Returns

Here, we simply calculate the difference between the initial cost of purchase and the final sale price to calculate our gains. This method does not account for the effects of the change in the time value of money.

### Compounded Annual Growth Rate

This is the rate of interest that would be needed for the investment to grow from its beginning balance to the ending balance. Here, the interest is computed on the interest plus the principal amount.





The formula for **CAGR** is as follows - **CAGR= (Ending Balance/Beginning Balance)^(1/number of years)**.

For example, if the amount invested is ₹10,000 and the value after 2 years is ₹12,000, the CAGR is computed as  $(12,000/10,000)^{(1/2)} = 9.54\%$ .

This method is a better way for calculating returns than calculating absolute returns because it takes into effect the change in the value of money overtime.

## 6. What are the methods used to evaluate the performance of a mutual fund scheme?

There are many quantitative measures to evaluate a fund's performance. Given below are some of the most popular methods of evaluation -

### 1) Information Ratio

The information ratio, also called IR, is a measure of the risk-adjusted return of the portfolio. This ratio compares the performance of a portfolio by setting up a benchmark in the form of an index or another mutual fund.

**IR = Rp - Rb/ Tracking error, where**

**Rp = portfolio return**

**Rb = return of benchmark**

**Tracking error = difference between the standard deviation of portfolio and benchmark.**



### 2) Sharpe Ratio

This ratio is similar to the IR, but it uses a risk-free security as a benchmark for comparison instead of choosing another performer in the market.

**Sharpe Ratio = Rp - Rf / standard deviation, where Rf = risk-free return**



## Capture Ratio

A capture ratio measures the intrinsic strength of a portfolio to survive market turbulence and the volatility of the market. Since the ratio covers how the fund performs in different market situations, it is basically a measure of the performance of the fund manager in ensuring high risk-adjusted returns to their investors.

The capture ratio is of two types -

### Upside Capture Ratio

This ratio is used to measure the performance of the fund manager during a bullish market stance.

$$\text{Upside Capture Ratio} = (\text{Fund returns during bull runs} / \text{Benchmark Returns}) * 100$$

### Downside Capture Ratio

This ratio is used to measure the performance of the fund manager during a bearish market stance.

$$\text{Downside Capture Ratio} = (\text{Fund returns during bear runs} / \text{Benchmark Returns}) * 100$$

## Treynor Ratio

Also known as the reward-to-volatility ratio, it is used to measure the returns in excess of those returns which could have been earned with a risk-free portfolio.

$$\text{Treynor Ratio} = R_p - R_f / \text{beta of the portfolio}$$

# Key Learning Points

1. The returns on a mutual fund scheme depend on factors like market volatility, industry performance, fees and expenses of a scheme.
2. Interest rate risk and credit risks are two risks associated with debt funds.
3. Mutual fund returns are measured in terms of absolute returns and CAGR.
4. Performance measures of mutual fund – information ratio, upside and downside capture ratio, Sharpe ratio, Treynor ratio.





# Multiple Choice Questions



**1. Which factors among them is a return driver?**

- a. market volatility
- b. industry experience
- c. fees and expenses of a scheme
- d. all of above

**2. Which among them is not a risk in an equity mutual fund scheme?**

- a. Volatility Risk
- b. Performance Risk
- c. Concentration Risk
- d. Default Risk

**3. Which of the following is a debt security?**

- a. debenture/ bonds
- b. certificate of deposits
- c. commercial paper
- d. All the above

**4. The risk of default by a company which issues its papers is also known as:**

- a. Interest rate risk
- b. payment risk
- c. credit risk
- d. corporate governance risk

**5. If too much of a particular stock or one particular sector is overbought compared to other stocks or sectors; it may result in loss if that particular stock or sector underperforms. Such risk is known as:**

- a. Credit risk
- b. Interest rate risk
- c. High exposure to equity
- d. Concentration risk



**6. Information ratio, upside and downside capture ratio, Sharpe ratio, Treynor ratio- how can they be categorised?**

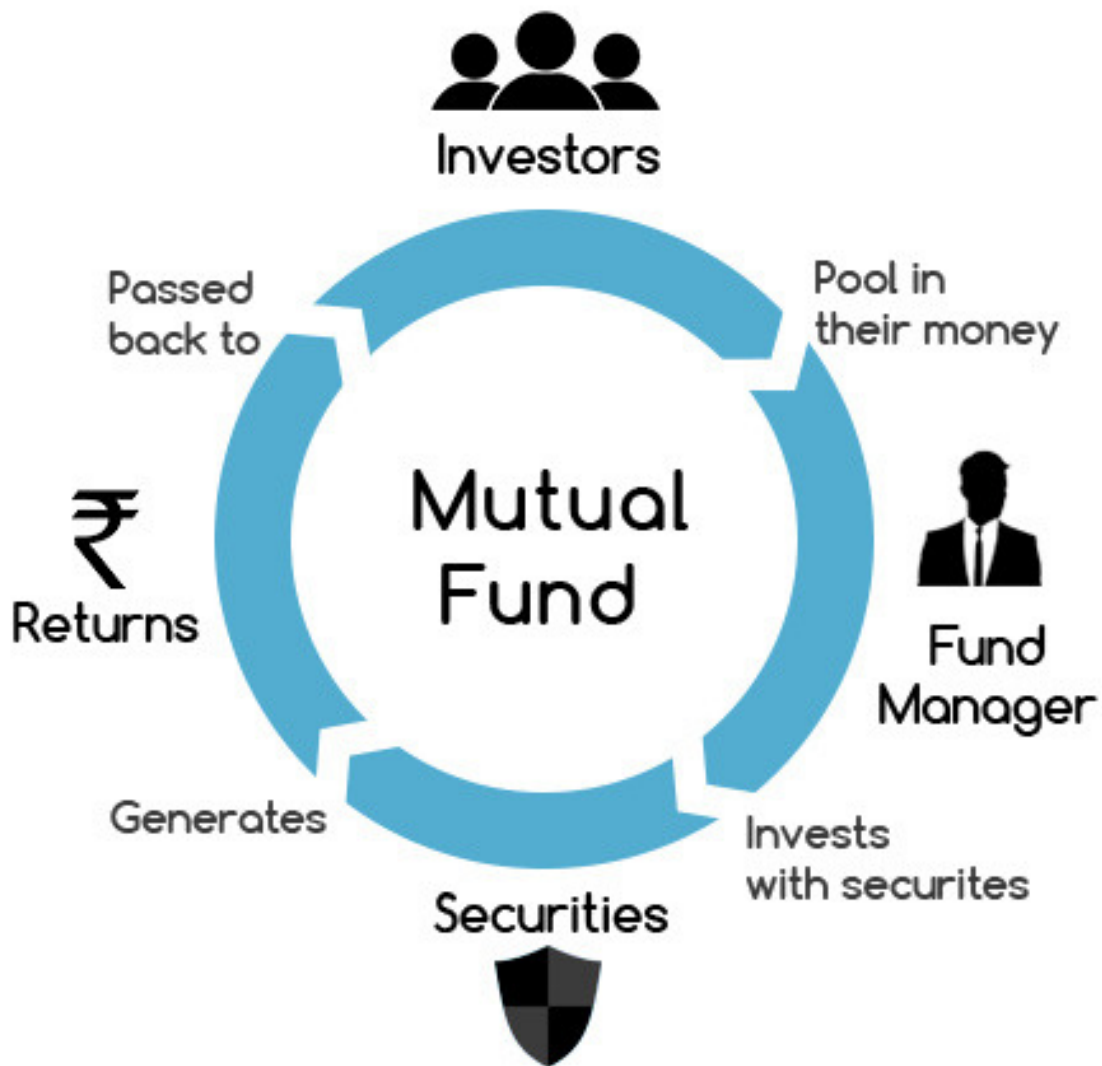
- a. Risk factors
- b. Performance measure of a fund
- c. Value drivers
- d. Growth drivers

**7. Measures of risk while evaluating a mutual fund scheme?**

- a. Beta
- b. Standard Deviation
- c. Both the above
- d. None of the above



# Chapter 6 : Mutual Fund Structure and Constituents



In this chapter, we will discuss the structure of a mutual fund and its important constituents. We will also discuss the regulatory authorities responsible for the functioning of the mutual funds industry, and talk about the rights and duties of a mutual fund investor.



# 1. How is a Mutual Fund formed?

The creation of a mutual fund involves the following authorities-

## The Sponsor

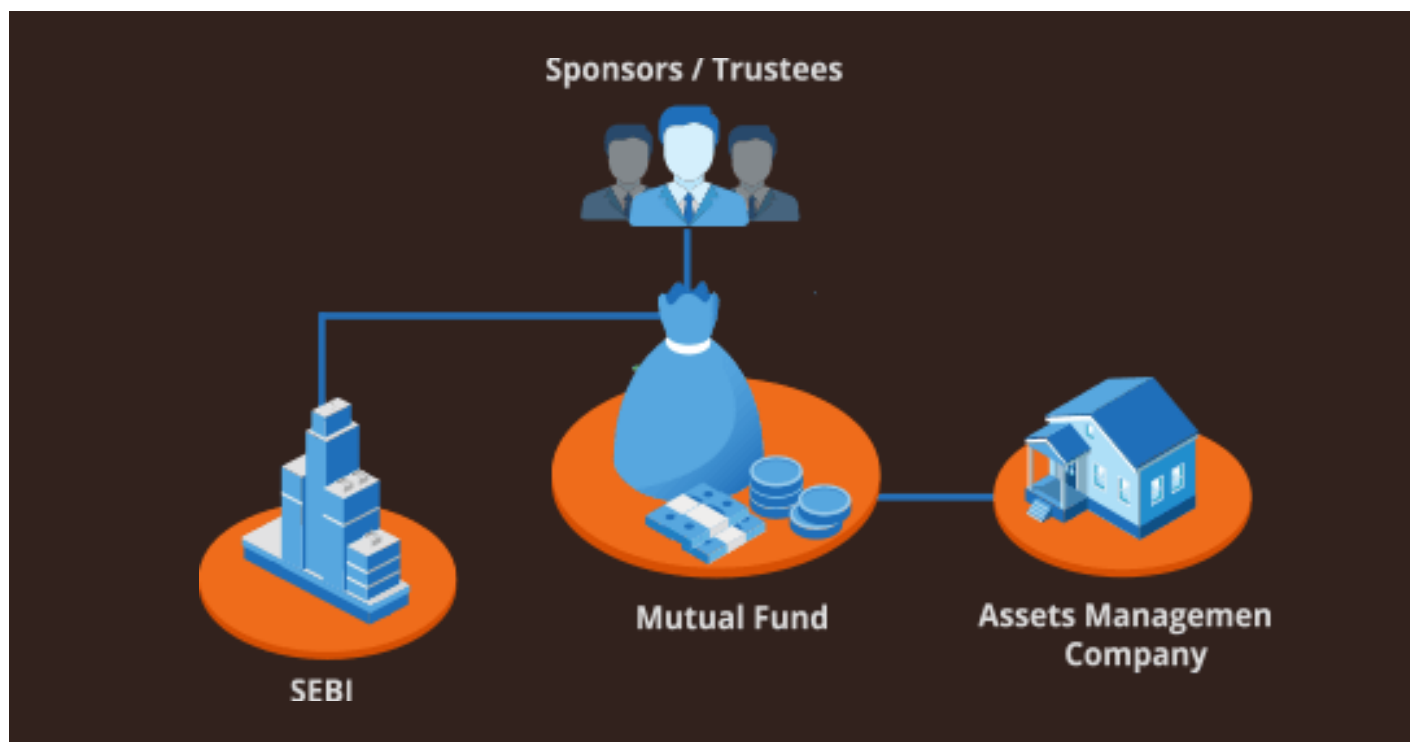
The sponsors are the persons or the groups of persons who come up with the idea of the mutual fund. They are the ones who will establish the fund and ask SEBI for its approval.

## The Trustees

After SEBI's approval, the sponsors form the public trust. The trustees of the scheme are placed to ensure that the funds of the investors are being managed properly, in line with the objectives of the scheme.

## The Asset Management Company (AMC)

The trustees appoint the AMC for their mutual fund. This AMC ensures that all the processes related to investment are carried out smoothly.



## 2. Key Personnel of an AMC

The key personnel of an entity are those people who have the authority to plan and direct the activities of the entity.



Apart from knowing your fund manager, it is important to understand these designations of the AMC as well -

- Chief Executive Officer (CEO)
- Chief Operating Officer (COO)
- Chief Executive Officer (CEO)
- Head- Sales
- Head- Fixed Income
- Fund Manager- Equity
- Fund Manager- Debt
- Head- Compliance
- Investor Relations Officer



The divisions within an AMC are made on the basis of which segment of the market the fund market handles. Under each fund manager, there are analysts and other professionals who assist the fund manager with the smooth functioning of the mutual fund schemes.

### 3. Which authorities regulate the Mutual Fund industry?

There are two regulatory bodies which oversee the functioning of the mutual fund industry- SEBI and AMFI.

#### **Securities Exchange Board of India (SEBI)**

SEBI regulates the mutual funds as a separate segment of the stock market. It builds the rules and regulations for all AMCs and the basic functioning of all mutual funds in the country

#### **.Association of Mutual Funds in India (AMFI)**

AMFI is an industry-standard organization for all mutual funds of the country. It is a not-for-profit organization that aims to spread investor awareness about the mutual funds industry.





## 4. What are the objectives of AMFI?

Given below are some of the objectives that AMFI has been set up for with the following objectives -

- To outline the ethical and uniform professional standards for every mutual fund operating under the association;
- To encourage its members and investors to maintain ethical business practices and regulations;
- To get AMCs, agents, distributors, advisories and other bodies involved in the capital market to comply with their guidelines;
- To help investors to air their grievances and register complaints against a fund manager or the fund house;
- To distribute information on Mutual Fund Sector and conduct research and workshops on various funds; and
- To spread awareness about the regulations regarding safe mutual fund investments throughout the country.



## 5. What are the rights and duties of mutual fund investors?

As per SEBI's guidelines, mutual fund investors are entitled to the following rights -

- 1) When an investor decides to invest in a mutual fund scheme, the investor has the right to go through the offer document.
- 2) The investor is entitled to receive the Key Information Document (KIM).
- 3) The investor has the right to know about the commissions which the distributor is earning. He also has the right to ask the distributor about advice regarding the scheme as well as the markets in general.
- 4) The investor is entitled to receive the annual report from the fund house every year.
- 5) The investor should also get an alert through email or SMS within 5 working days after he has made a lump sum or an additional purchase or in case of a SIP.



Following are the duties of the investors -

- The investor should update his personal information
- The investor should make proper nominations for his/her investments .
- The investor should take care of the switches that he decides to make from one scheme to the other.
- The investor should be careful with the documents. They should carefully go through the document and study his/her investments to see whether all information is entered correctly.

## Key Learning Points

1. The regulatory structure of mutual fund comprises of a sponsor, the asset management company, trustees and a custodian.
2. There can be more than once sponsor in the setting up of a mutual fund company.
3. Only SEBI approved AMC can invests in various types of securities.
4. Trustees are appointed supervise the working of the mutual fund in compliance with the regulation of SEBI.
5. As per the regulations of SEBI, the trustee company shall be in no relation or association with the sponsors.
6. AMFI is the apex body for industry association of mutual funds.





# Multiple Choice Questions



**1. The 3 tier of regulatory structure of mutual funds in India in sequence.**

- a. Public Trust – Sponsor – Asset Management Company
- b. Sponsor - Public Trust - Asset Management Company
- c. Public Trust - Asset Management Company – Sponsor
- d. Asset Management Company – Public Trust – Sponsor

**2. Which body regulates the working of mutual funds in India?**

- a. RBI
- b. AMFI
- c. SEBI
- d. NSE

**3. Industry association for the mutual fund industry**

- a. SEBI
- b. AMFI
- c. UTI
- LIC

**4. Which among them is not an objective of AMFI?**

- a. Encourages members and investors to maintain ethical business practices and regulations
- b. Outlines ethical and uniform professional standards in mutual fund operation.
- c. Investors can approach AMFI to air their grievances and register complaints against a fund manager or the fund house'
- d. Advice investors on which funds to choose



**5. Which of the following is not a right of the investor?**

- a. The investor is entitled to receive the Key Information Document (KIM)
- b. The investor is entitled to receive the annual report from the fund house every year.
- c. The investor is entitled to high returns on his investment.
- d. The investor should also get an alert through email or SMS within 5 working days after he has made a lump sum or an additional purchase or in case of a SIP.

**6. Which of the following is a duty of an investor**

- a. The investor should update his personal information
- b. The investor should make proper nominations.
- c. The investor should take care of the switches that he decides to make from one scheme to the other.
- d. All of the above



# Chapter 7: Must Know Concepts and Terms



**This chapter discusses some of the basic concepts and terms which each investor should be aware of while transacting in the mutual funds industry.**



# 1.What is the expense ratio?

Expense ratio is the fee that is charged by an Asset Management Company for managing the assets to manage the funds of the investors.

For instance: An investor invests ₹ 100000 and the expense ratio is 2%, then ₹ 2000 is used for the expenses involving the management of the fund. The investment companies incur various costs for managing the funds. Some of these include advertisement and promotion costs, fund manager fees, etc..

## 2. What is NAV?

The NAV or Net Asset Value is a fund's per unit market value.

**NAV = Net assets of the scheme / Number of units outstanding**

When the stock markets perform well, the NAV goes up and vice versa. It is somewhat like the share price of a particular company. However a higher NAV does not represent a better fund.



### Net Asset Value Formula

$$\text{Net Asset Value} = \frac{\text{Fund Assets} - \text{Fund Liabilities}}{\text{Total number of Outstanding Shares}}$$



## 3. What is AUM?

AUM stands for assets under management.

A particular fund house has multiple schemes. Every scheme has investors who have invested their money into this. The total of all the investors in all schemes put together is termed as assets under management.

It is the total market value of assets that an investment company manages on behalf of its investors.

## 4. What is exit load?

Exit load refers to that fee which an investor has to pay for leaving the scheme before a predetermined period.



For instance:

Suppose, the exit load is 1% for 1 year. It means that the investor will have to shell out 1% of his total investment value if he plans to withdraw his fund before 1 year. After 1 year, no exit load is charged.

This is basically enacted to ensure that the investor invests for the long term and does not pull out his funds immediately.

## 5. What is a factsheet?

A factsheet is a document which gives an overview of a mutual fund. It contains the list of securities that the fund has invested in and also contains other data such as 1 year, 3 year, 5 year and since inception returns.

It also contains the different ratios for example, the sharpe ratio, the point to point returns etc. An investor can go through this sheet to ascertain whether he is invested in the right scheme based on the holdings of that particular fund.

## 6. What is benchmark?

A benchmark is a standard against which the performance of a security, a mutual fund or a fund manager can be ascertained. It is a preset list of securities which is used for the comparison with an actual portfolio.

Benchmarks are usually broad market indices like BSE Sensex, CNX Nifty which are used to compare the different mutual funds.



## 7. What is a Total Return Index?

It is a type of equity index which tracks the capital gains of a group of stocks and assumes that the dividends are added back to the index.

When we assume this, it means that the dividends that are received from the stock are reinvested back into the same stock from which dividend has been received.



## 8. What is an SIP?

An SIP, or a **Systematic Investment Plan** is the process of investing periodically be it weekly, fortnightly, monthly or quarterly.

Here the investment is done irrespective of whether the markets are up or down. In case the NAV is down, more units are purchased and in case the NAV is up, lesser units are bought.

This helps in investing over the long term after taking into account the bull run and the bear run.

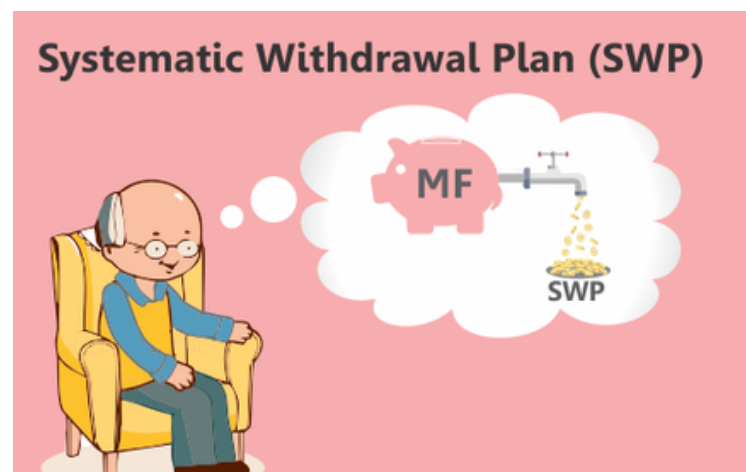
It is like an EMI where installments accrue for a specific wealth creation goal. An investor might choose multiple SIP's for different goals. The biggest benefit is that in this one does not need to time the markets.

## 9. What is an SWP?

A **Systematic Withdrawal Plan** (SWP) w.r.t. to a mutual fund scheme allows an individual to withdraw funds periodically by selling off the proportionate units of the scheme.

An individual might need monthly cash inflows when he retires or even for other necessary expenses which he incurs on a monthly basis.

Therefore, when he puts his money in a mutual fund, and then sets up an SWP on that fund, he will receive periodical payments through deductions from the fund. This can serve as an alternate source of income for investors..



## 10. What is an STP?

An STP, short for **Systematic Transfer Plan**, is a scheme that allows an investor to transfer funds or units from one scheme to another offered by the same mutual fund house.

An investor can use this system to maintain a balance between their investments in two different segments of the market. This ensures diversification of funds and protects investors from concentration risk as well.



# Key learning points

1. Expenses ratio refers to the percentage of funds incurred in meeting expenses in setting up of the mutual fund.
2. NAV of a mutual fund changes every day.
3. Assets under management is the sum total of the mutual fund scheme.
4. Exit load is the charge to be paid by an investor before exiting from a mutual fund scheme before the end of the term of the scheme.
5. Fact sheet helps an investor to assess the securities in which the fund has invested over the past years.
6. Benchmark is basically the standard against which the performance of the mutual fund scheme is ascertained.
7. Total return index assumes that the dividend paid by the stocks is reinvested in them.
8. Investment in SIP can be started with as low as Rs. 500/-
9. SWP is the fund withdrawal plan offered by various mutual fund schemes.
10. STP is the transfer plan helping the investors to transfer funds promptly and systematically in the other scheme.





# Multiple Choice Questions



## 1. What is expense ratio of a mutual fund?

- a. Percent of funds charged by the financial planner on advising the client
- b. Percent of funds paid to the regulator for its services
- c. Percent of funds charged by AMCs to manage the funds of an investor
- d. Percent of funds charged on pre-mature withdrawal of funds

## 2. NAV stands for

- a. Net Annual Value
- b. Net Assets Value
- c. Nominal Amount Value
- d. None of the above

## 3. AUM stands for

- a. Assets Used by Management
- b. All Under Money
- c. Assets Undertaken by Management
- d. Assets Under Management

## 4. AUM is

- a. Market value of assets pledged by a company
- b. Purchase cost of total assets managed by a company
- c. Market value of total assets managed by an asset management company
- d. Market Value of assets sold by an asset management company

## 5. What is exit load?

- a. A fee paid by an investor to select more than one fund
- b. A fee paid by AMCs to investors to withdraw their money prematurely
- c. A fee paid by an investor on failure of payment of an installment
- d. A fee that an investor has to pay on leaving a fund before a pre-determined period



## **6. A factsheet contains?**

- a. An overview of a mutual fund scheme
- b. List of securities that the fund has invested in
- c. Historical returns information
- d. All of the above

## **7. What is a benchmark?**

- a. Benchmark is a standard against which the performance of a mutual fund or security is compared.
- b. Benchmark is the return on the best performing mutual fund scheme
- c. Benchmark is the best ever return earned by a fund.
- d. None of the above.

## **8. What is a total return index?**

- a. Total Return Index tracks the capital gain of a group of stocks and assumes dividends are re-invested back into the index.
- b. Total Return Index is the index of all stocks in a portfolio
- c. Both a and b
- d. None of the above

## **9. What is a SIP?**

- a. SIP is the process of investing periodically
- b. Systematic Investment Plan
- c. Both a and b
- d. Only b

## **10. Which of the following statement is true about SIP?**

- a. In SIP, an investor can deposit money whenever he feels like
- b. In SIP, an investors times the market for better returns
- c. In, SIP investors will have rupee cost averaging benefit
- d. None of the above



## **11. Benefits of Systematic Withdrawal Plan**

- a. Systematic withdrawal plan helps in achieving a regular income.
- b. Protects the investors from overspending
- c. Can be used as a part of retirement planning
- d. All of the above

## **12. Systematic Transfer Plan allows an investor to transfer funds from one scheme to another scheme of any fund?**

- a. True
- b. False



# **Chapter 8: Facilities and Services**

## **- Investors**



**In this chapter, we will discuss some of the basics surrounding the investment process and answer some important questions relevant to our understanding of the mutual fund industry. This chapter will help us understand the concept of a mutual fund adviser and will cover some of the basic facilities we are offered to make our investment process easier.**



# 1. What is a distribution channel?

In simple terms, a distribution channel is a connection between the mutual fund and the investor. A distribution channel is our way to access a mutual fund and invest in it.

These days, with the growth of the usage of technology in the industry, we can segregate the different distribution channels into two categories- **traditional** and **modern channels**.

## 2. What are the traditional distribution channels of mutual fund?

The traditional distribution channels of a mutual fund include -

**Through an IFA (Independent Financial Adviser)-** Mutual funds initially started with selling through a distributor who would bring in the application forms and get it filled up from the client and collect the cheque. Then he would deposit to the necessary fund house.

**Through regional distributor-** Here mutual funds were distributed through a distributor who would have a presence across the state or the city. He would be having a few employees and would also have distributors empanelled under him.

**Through a National Distributor-** Here there would be a distributor and he would empanel different IFA's under him and they would have a pan India presence. Its examples include HDFC Bank, NJ India Invest etc.

## 3. What are the new distribution channels of mutual fund?

The new distribution channels of mutual funds are as follows:-

**Direct Plans-** In 2013, SEBI introduced the option of direct plans under which an investor by logging into the website of the fund house could invest directly with the fund house thereby eliminating the distributor in the process. Here the expense ratio would be lesser compared to the regular plans.

**E commerce sites & Apps-** ET Money, Paytm Money and Groww etc have allowed the investors to invest through them into the direct plans of mutual funds with the help of their app.

**Robo Advisory websites-** A lot of websites like paisabazaar.com, scripbox.com etc. ask a few questions to understand about the risk appetite of investors enabling them to find funds which are suited to them. These take data from the investors and then make them invest through the sites.



## 4. What is a mutual fund adviser?

A mutual fund adviser is a qualified professional who assists investors in understanding the nuances and the purposes of a fund.

A mutual fund adviser's prime job is to figure out which funds are the right investments for their clients.

## 5. What is the need for a mutual fund advisor?

We need a mutual fund adviser because -

- 1)An adviser helps us in making informed decisions, while keeping our financial goals and obligations in mind.
- 2)A mutual fund adviser helps us when we are not sure of our risk profile and we need help in understanding our own investment objectives and purposes.
- 3)An adviser does the risk profiling of every investor who has hired them, and then recommends them a mix of different schemes and plans accordingly.
- 4)Irrespective of bear and bull markets, an adviser steadies the nerves of the investors and keeps the emotions of the investors under check.
- 5)The investor's time is saved when he hires a mutual fund adviser. How? The adviser helps us save our time by assisting our KYC procedure and making sure to complete all our formalities for us before we begin investing.

## 6. What are the steps to follow to become a mutual fund adviser?

In India, one has to hold certain qualification to become a mutual fund agent; the agent's role encompasses the role of an adviser as well as a distributor of funds.

The following steps should be followed to become a mutual fund agent-

- Obtain a valid certification from the National Institute of Securities Market (NISM) by passing their certification examination NISM Series V-A: Mutual Fund Distributors Certification Examination.
- Obtain a valid ARN code and certificate from AMFI.



- Complete the duly filled empanelment form with the fund house and submit the Know Your Distributor (KYD) documents.
- After this, when you become an agent, you can distribute the schemes of the different fund houses to your clients as an adviser.

## 7. What are the types of commission a mutual fund adviser is entitled to?

The mutual fund advisor is entitled to the following:-

- **Upfront commission-** This is the fixed percentage given to the distributor for selling a scheme. Suppose an investor has made an investment of Rs 100000, and the upfront commission is 0.5%, then he is entitled to Rs 500 as the upfront commission.
- **Trail Commission-** This is the amount that the distributor is entitled to get for as long as the funds are invested with the fund house under his ARN code. This amount he gets on a proportionate basis.

For instance if an investor has invested 1 lakh and he keeps the fund for 11 months and the trail rate is 0.8%, then the distributor is entitled to receive 0.8% of 1,00,000 for 11 months i.e  $.8\% \times 100000 \times 11/12$ .

## 8. What qualities should we check in a mutual fund adviser before appointing them?

Investing for future goals is a serious business, so the person you choose to be your financial adviser is really important.

These are some qualities you should check in a financial adviser.

### Qualification and experience

A professional degree like a certified financial planner (C.F.P.) or SEBI registered adviser (RIA) or similar degree is preferable. People with more years of experience in the profession and in markets are preferable as well.

### Compensation of the adviser

If the adviser depends on selling funds for his compensation, then there could be a bias to push a particular type of schemes or fund. An investor should try and assess that his adviser is not involved in such dealings. An adviser with a fixed fee for their services can be preferred.



### Past track record

It is difficult to assess an adviser's past track record in India. Fortunately, you can ask around for referrals and discuss with past and existing clients of the adviser.

### Accessibility

It is important that the person whom you are entrusting with your financial data is accessible. The adviser should always be able to answer your queries. Dealings should be very clear and transparent with no hidden agenda.

### Confidentiality

You would want your finances and all information about it to be confidential. Your adviser should maintain client confidentiality and not discuss your finances with others.



## 9. Frequently Asked Questions

### Q. Can a NRI invest in mutual funds?

Yes, NRIs can invest in mutual funds without seeking any special approval from any authority.

An NRI can invest in two ways - a repatriable and a non-repatriable way. The differences between the two have been discussed below.

Repatriable basis	Non-Repatriable basis
Needs a bank account in India.	Not needed
Investment amount can be sent back through the NRE Account as a normal bank transaction.	Investment funds can be rendered directly from the NRO Account.

**NRE Account stands for Non- resident rupee account & NRO Account stands for Non-resident ordinary rupee account**



## Q.What are the Know Your Customer (KYC) requirements and why are they important?

KYC is the basic requirement of getting all the mandatory documents listed below with the mutual fund house.

KYC is important because without the submission and verification of the documents, an investor will not be able to start investment.

This procedure is basically an identity check to avoid any money laundering or fraudulent activities later.

The documents are:

1. Permanent Account Number (PAN)
2. Identity and address proof such as Aadhar card, passport, voter id (as per the requirement)
3. KYC Form
4. Crossed cheque
5. Recent passport sized coloured photograph.

Note: The above documents shall be self-attested copies and original for verification.

## Q. What is eKYC and process and features of eKYC?

eKYC is basically a paperless AADHAR card based process of fulfilling the KYC requirements before investing in the mutual funds.

The special feature or advantage of eKYC is to expedite the process of KYC by reducing paper work and thereby making the process easier and faster.

## Q. What are the payment mechanisms available for making purchase and sale transactions?

For purchasing mutual fund schemes, investors can use online banking, debit card payment, and Cheque. For SIP, payments are mostly automated and gets debited from the bank account of the investor at specified intervals.

Such procedure is fixed at the beginning of investment. When mutual fund is redeemed, the amount gets deposited to the investor's bank account or he gets a physical cheque depending on which option is chosen earlier.





## Q. What are the different plans available in a mutual fund scheme to an investor?

Every mutual fund scheme offers two plans to invest:

- a) Direct plan
- b) Regular Plan

Investors can choose any one plan as per their suitability.

**A Direct Plan** invests directly in a mutual fund scheme without taking any help of a distributor. The direct plan will have low annual expenses as the distributor fee or commission need not be paid in this plan. The expenses will be lower by around 0.75% - 1% per annum in case of equity funds

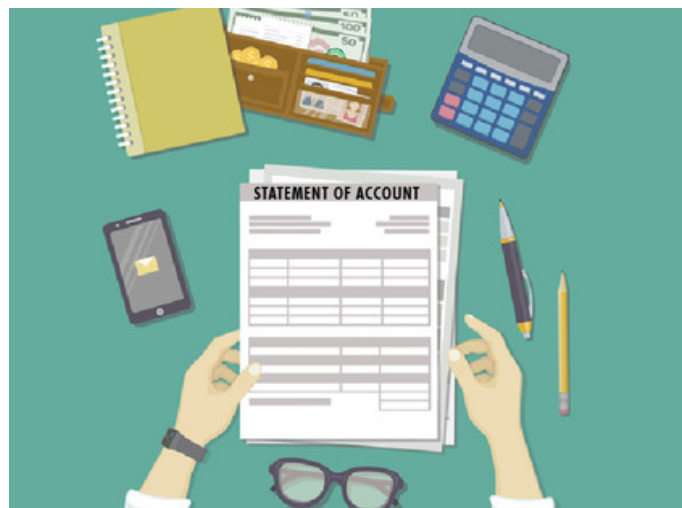
**A Regular Plan** invests in a mutual fund scheme through a distributor. Obviously, expenses will be higher compared to direct plans, but the entire process of investing will be taken care of by the distributor. Often, the distributor offers advisory services as well.

## Q. What is an SOA?

**Mutual Fund Statement of Account** (SOA) or Consolidated Account Summary lists all the updated details of your investment and your profile details too.

An investor should check-

1. Name and address
2. Email ID , contact nos
3. Bank details like account no and RTGS no.
4. Nominee mentioned or not
5. Cost of Investment
6. Number of Units bought, sold and balance
7. Total amount invested
8. Current Market Value of Investment based on NAV
9. Time period to maturity (if close-ended fund)





# Key learning points

1. There are various distribution channels available for mutual funds, and they can be of the traditional or modern category.
2. A mutual fund adviser helps you in investing under a the right plan based on your preferences.
3. An NRI can invest in mutual fund without seeking permission from any special authority under repatriable and non-repatriable basis.
4. KYC for mutual funds is important to avoid any kind of siphoning of funds or fraudulent activities later.
5. For purchasing mutual fund schemes, investors can use online banking, debit card payments, etc..
6. Every mutual fund scheme offers two plans for their investment - a direct plan or a regular plan.





# Multiple Choice Questions



**1. Under which schedule of SEBI regulations is the advertisement code for mutual funds mentioned?**

- a. Ninth
- b. Tenth
- c. Sixth
- d. Seventh

**2. Is the color coding scheme in mutual funds replaced by Riskometer?**

- a. True
- b. False
- c. Both exists

**3. Majorly under how many categories is mutual fund divided:**

- a. 2
- b. 3
- c. 4
- d. 5

**4. Can NRI invest in a mutual fund scheme in India?**

- a. Yes
- b. No

**5. What are the types of commission earned by a mutual fund adviser?**

- a. Advisory fee
- b. Upfront commission
- c. Trail commission
- d. All of the above



**6. What one is one of the new distribution channels of a mutual fund scheme?**

- a. Direct plan
- b. Through regional distributor
- c. National distributor
- d. None of the above

**7. Can cheques be used for purchasing the mutual fund units?**

- a. Yes
- b. No
- c. Depends on the mutual fund scheme.

**8. Is it compulsory to get the KYC done before investing in mutual fund?**

- a. Yes
- b. No
- c. Depends on the mutual fund scheme.

**9. Which one of the following is a traditional distribution channel?**

- a. Through regional distributor
- b. National distributor
- c. Independent Financial Adviser
- d. All of the above

**10. Expenses are higher in which plan?**

- a. Direct plan
- b. Indirect Plan
- c. Same expenses in both plans



# Answer Key



## Chapter-1

### Answer Key

1	c
2	c
3	d
4	b
5	b
6	d
7	c
8	d

## Chapter-2

### Answer Key

1	d
2	b
3	c
4	b
5	a
6	d
7	c

## Chapter-3

### Answer Key

1	c
2	d
3	a
4	b
5	a
6	c
7	b
8	a



# Chapter-4

## Answer Key

1	b
2	c
3	d
4	b
5	c
6	d
7	c
8	b

# Chapter-5

## Answer Key

1	d
2	d
3	d
4	c
5	d
6	b
7	c

# Chapter-6

## Answer key

1	b
2	c
3	b
4	d
5	c
6	d



# Chapter-7

## Answer key

1	c
2	b
3	d
4	c
5	d
6	d
7	a
8	a
9	c
10	c
11	d
12	b

# Chapter-8

## Answer Key

1	c
2	a
3	a
4	a
5	d
6	a
7	c
8	a
9	d
10	b





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