How Mutual Funds Work

These days you are hearing more and more about mutual funds as a means of investment. If you are like most people, you probably have most of your money in a bank savings account and your biggest investment may be your home. Apart from that, investing is probably something you simply do not have the time or knowledge to get involved in. You are not the only one. This is why investing through mutual funds has become such a popular way of investing.

What is a Mutual Fund?

A mutual fund is a pool of money from numerous investors who wish to save or make money just like you. Investing in a mutual fund can be a lot easier than buying and selling individual stocks and bonds on your own. Investors can sell their shares when they want.

Professional Management. Each fund's investments are chosen and monitored by qualified professionals who use this money to create a portfolio. That portfolio could consist of stocks, bonds, money market instruments or a combination of those.

Fund Ownership. As an investor, you own shares of the mutual fund, not the individual securities. Mutual funds permit you to invest small amounts of money, however much you would like, but even so, you can benefit from being involved in a large pool of cash invested by other people. All shareholders share in the fund' s gains and losses on an equal basis, proportionately to the amount they've invested.

Mutual Funds are Diversified

By investing in mutual funds, you could diversify your portfolio across a large number of securities so as to minimise risk. By spreading your money over numerous securities, which is what a mutual fund does, you need not worry about the fluctuation of the individual securities in the fund's portfolio.

Mutual Fund Objectives

There are many different types of mutual funds, each with its own set of goals. The investment objective is the goal that the fund manager sets for the mutual fund when deciding which stocks and bonds should be in the fund's portfolio.

For example, an objective of a growth stock fund might be: This fund invests primarily in the equity markets with the objective of providing long-term capital appreciation towards meeting your long-term financial needs such as retirement or a child' s education.

Depending on investment objectives, funds can be broadly classified in the following 5 types:

- **Aggressive growth** means that you will be buying into stocks which have a chance for dramatic growth and may gain value rapidly. This type of investing carries a high element of risk with it since stocks with dramatic price appreciation potential often lose value quickly during downturns in the economy. It is a great option for investors who do not need their money within the next five years, but have a more long-term perspective. Do not choose this option when you are looking to conserve capital but rather when you can afford to potentially lose the value of your investment.

- As with aggressive **growth**, growth seeks to achieve high returns; however, the portfolios will consist of a mixture of large-, medium- and small-sized companies. The fund portfolio chooses to invest in stable, well established, blue-chip companies together with a small portion in small and new businesses. The fund manager will pick, growth stocks which will use their profits grow, rather than to pay out dividends. It is a medium - long-term commitment, however, looking at past figures, sticking to growth funds for the long-term will almost always benefit you. They will be relatively volatile over the years so you need to be able to assume some risk and be patient.

- A combination of **growth and income** funds, also known as **balanced funds**, are those that have a mix of goals. They seek to provide investors with current income while still offering the potential for growth. Some funds buy stocks and bonds so that the portfolio will generate income whilst still keeping ahead of inflation. They are able to achieve multiple objectives which may be exactly what you are looking for. Equities provide the growth potential, while the exposure to fixed income securities provide stability to the portfolio during volatile times in the equity markets. Growth and income funds have a low-to-moderate stability along with a moderate potential for current income and growth. You need to be able to assume some risk to be comfortable with this type of fund objective.

- That brings us to **income funds**. These funds will generally invest in a number of fixed-income securities. This will provide you with regular income. Retired investors could benefit from this type of fund because they would receive regular dividends. The fund manager will choose to buy debentures, company fixed deposits etc. in order to provide you with a steady income. Even though this is a stable option, it does not go without some risk. As interest-rates go up or down, the prices of income fund shares, particularly bonds, will move in the opposite direction. This makes income funds interest rate sensitive. Some conservative bond funds may not even be able to maintain your investments' buying power due to inflation.

- The most cautious investor should opt for the **money market mutual** fund which aims at maintaining capital preservation. The word preservation already indicates that gains will not be an option even though the interest rates given on money market mutual funds could be higher than that of bank deposits. These funds will pose very little risk but will also not protect your initial investments' buying power. Inflation will eat up the buying power over the years when your money is not keeping up with inflation rates. They are, however, highly liquid so you would always be able to alter your investment strategy.

Closed-End Funds

A closed-end fund has a fixed number of shares outstanding and operates for a fixed duration (generally ranging from 3 to 15 years). The fund would be open for subscription only during a specified period and there is an even balance of buyers and sellers, so someone would have to be selling in order for you to be able to buy it. Closed-end funds are also listed on the stock exchange so it is traded just like other stocks on an exchange or over the counter. Usually the redemption is also specified which means that they terminate on specified dates when the investors can redeem their units.

Open-End Funds

An open-end fund is one that is available for subscription all through the year and is not listed on the stock exchanges. The majority of mutual funds are open-end funds. Investors have the flexibility to buy or sell any part of their investment at any time at a price linked to the fund's Net Asset Value.

Mutual Funds Advantages

As an investor, you would like to get maximum returns on your investments, but you may not have the time to continuously study the stock market to keep track of them. You need a lot of time and knowledge to decide what to buy or when to sell. A lot of people take a chance and speculate, some get lucky, most don t. This is where mutual funds come in. Mutual funds offer you the following advantages :

Professional management. Qualified professionals manage your money, but they are not alone. They have a research team that continuously analyses the performance and prospects of companies. They also select suitable investments to achieve the objectives of the scheme. It is a continuous process that takes time and expertise which will add value to your investment. Fund managers are in a better position to manage your investments and get higher returns.

Diversification. The cliché, "don't put all your eggs in one basket" really applies to the concept of intelligent investing. Diversification lowers your risk of loss by spreading your money across various industries and geographic regions. It is a rare occasion when all stocks decline at the same time and in the same proportion. Sector funds spread your investment across only one industry so they are less diversified and therefore generally more volatile.

More choice. Mutual funds offer a variety of schemes that will suit your needs over a lifetime. When you enter a new stage in your life, all you need to do is sit down with your financial advisor who will help you to rearrange your portfolio to suit your altered lifestyle.

Affordability. As a small investor, you may find that it is not possible to buy shares of larger corporations. Mutual funds generally buy and sell securities in large volumes which allow investors to benefit from lower trading costs. The smallest investor can get started on mutual funds because of the minimal investment requirements. You can invest with a minimum of Rs.500 in a Systematic Investment Plan on a regular basis.

Tax benefits. Investments held by investors for a period of 12 months or more qualify for capital gains and will be taxed accordingly (10% of the amount by which the investment appreciated, or 20% after factoring in the benefit of cost indexation, whichever is lower). These investments also get the benefit of indexation.

Liquidity. With open-end funds, you can redeem all or part of your investment any time you wish and receive the current value of the shares. Funds are more liquid than most investments in shares, deposits and bonds. Moreover, the process is standardised, making it quick and efficient so that you can get your cash in hand as soon as possible.

Rupee-cost averaging. With rupee-cost averaging, you invest a specific rupee amount at regular intervals regardless of the investment's unit price. As a result, your money buys more units when the price is low and fewer units when the price is high, which can mean a lower average cost per unit over time. Rupee-cost averaging allows you to discipline yourself by investing every month or quarter rather than making sporadic investments.

The Transparency. The performance of a mutual fund is reviewed by various publications and rating agencies, making it easy for investors to compare fund to another. As a unit holder, you are provided with regular updates, for example daily NAVs, as well as information on the fund's holdings and the fund manager's strategy.

Regulations. All mutual funds are required to register with SEBI (Securities Exchange Board of India). They are obliged to follow strict regulations designed to protect investors. All operations are also regularly monitored by the SEBI.