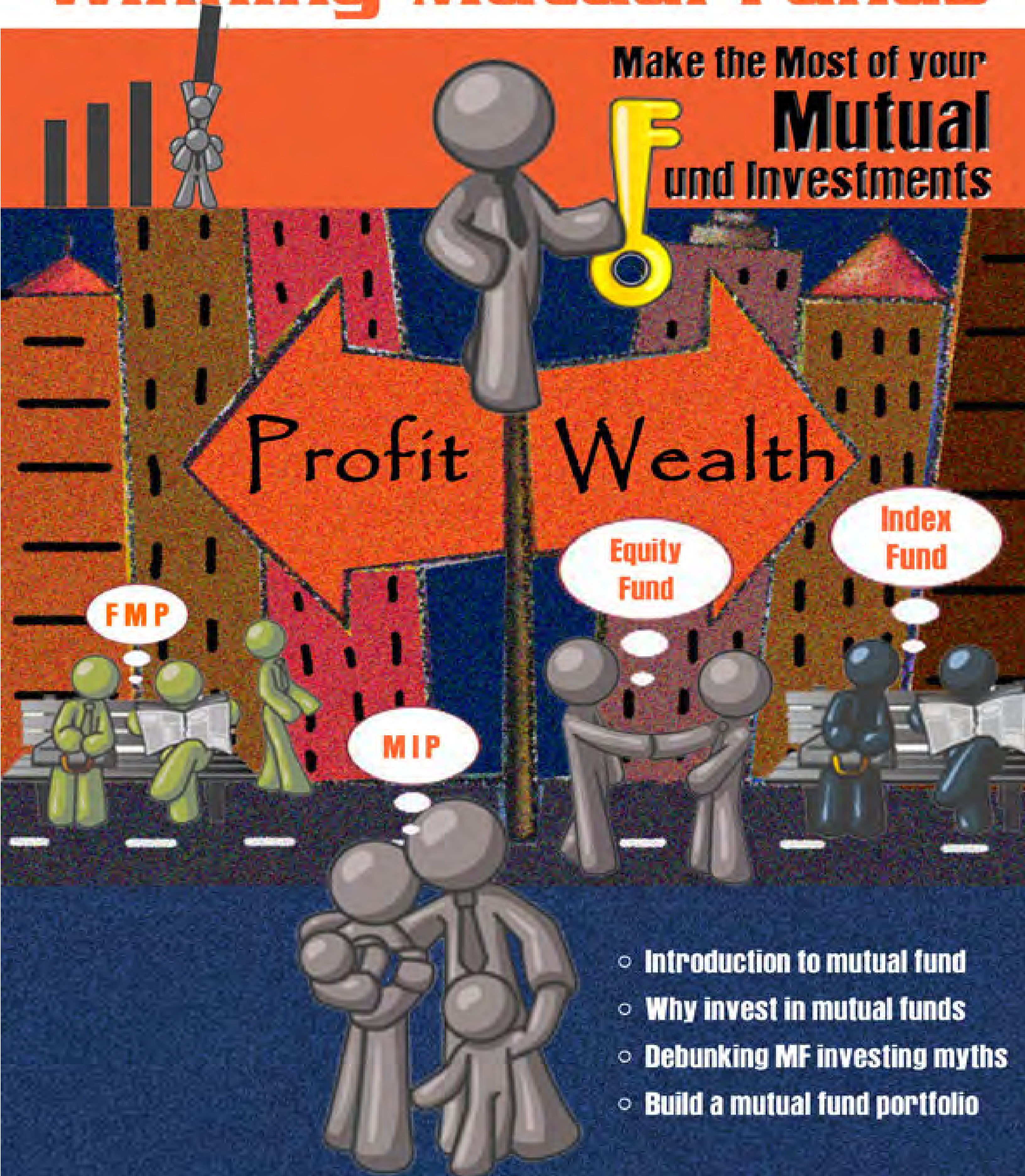
How to Select Winning Mutual Funds



- Introduction to mutual fund
- Why invest in mutual funds
- Debunking MF investing myths
- Build a mutual fund portfolio

Preface

Many investors are absolutely fascinated about investing in mutual funds. But, in our opinion mere fascination is not enough. Investing wisely and with the right insights helps one to make the right investment decision. If investors do not have the right perspective, mutual fund investing could be a conundrum, and with mis-selling from mutual fund distributors, investors could go down the wrong path, reaching an unwanted destination. Also, now that the distributors' incentives for selling mutual funds are stopped, they are bound to be disinterested in servicing their clients, thereby adding more agony to the woes of the investor.

Hence, in such a case it is imperative that investors understand the various nuances that go into mutual fund investments. To understand all this requires some words of experience.

Through this guide, Personal FN has tried to capture its experience for the reader's benefit. , This will enable readers to unravel some of the mysteries and debunk some of the misconceptions of mutual fund investments. We hope it will be an informative read.

Wish you all always Happy Investing!!

Personal FN Research Team

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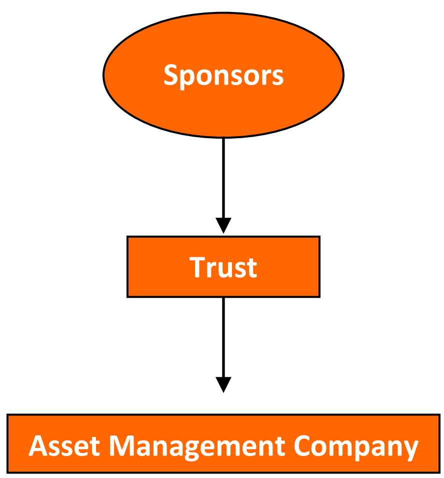
Introduction

Mutual fund industry and structure

Let's begin with the mutual fund industry in India. The Indian mutual fund industry has 41 players. The number of public sector players has reduced from 11 to 6. The public sector has gradually receded into the background, passing on a large chunk of market share to private sector players.

The Association of Mutual Funds in India (AMFI) is the industry body set up to facilitate the growth of the Indian mutual fund industry. It plays a pro-active role in identifying steps that need to be taken to protect investors and promote the mutual fund sector. It is noteworthy that AMFI is not a Self-Regulatory Organisation (SRO) and its recommendations are not binding on the industry participants. By its very nature, AMFI has an advisor's or a counsellor's role in the mutual fund industry. Its recommendations become mandatory if and only if the Securities and Exchange Board of India (SEBI) incorporates them into the regulatory framework it stipulates for mutual funds.

The Indian mutual fund industry follows a 3-tier structure as shown below:



Let's understand what each of these terms means and their roles in the mutual fund industry.

1. **Sponsors**

   They are the individuals who think of starting a mutual fund. The Sponsor approaches SEBI, the market regulator and also the regulator for mutual funds. Not everyone can start a mutual fund. SEBI will grant a permission to start a mutual fund only to a person of integrity, with significant experience in the financial sector and a certain minimum net worth. These are just some of the factors that come into play.

2. **Trust**

   Once SEBI is satisfied with the credentials and eligibility of the proposed Sponsors, the Sponsors then establish a Trust under the Indian Trust Act 1882. Trusts have no legal identity in India and thus cannot enter into contracts. Hence the Trustees are the individuals authorized to act on behalf of the Trust. Contracts are entered into in the name of the Trustees. Once the Trust is created, it is registered with SEBI, after which point, this Trust is known as the mutual fund.

3. **Asset Management Company (AMC)**

   The Trustees appoint the AMC, which is established as a legal entity, to manage the investor's (unit holder's) money. In return for this money management on behalf of the mutual fund, the AMC is paid a fee for the services provided. This fee is to be borne by the investors and is deducted from the money collected from them.

The AMC has to be approved by SEBI and it functions under the supervision of its Board of Directors, and also under the direction of the Trustees and the regulatory framework established by SEBI. It is the AMC, which in the name of the Trust, that floats new schemes and manages these schemes by buying and selling securities.

So broadly, so far, we have the Sponsors, the Trust and the AMC.

Apart from these parties, we also have the following:

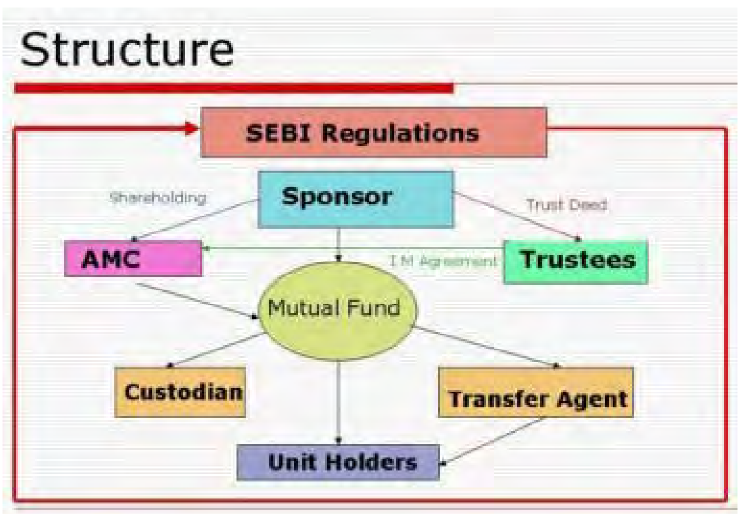
1. **Custodian**

   The Custodian maintains the custody of the securities in which the scheme invests. It also keeps a tab on corporate actions such as rights, bonus and dividends declared by the companies in which the fund has invested. The Custodian is appointed by the Board of Trustees. The Custodian also participates in a clearing and settlement system through approved depository companies on behalf of mutual funds, in case of dematerialized securities.

2. **Transfer Agents**

   Registrar and Transfer Agents (RTAs) maintain the investor's (unit holder's) records, reducing the burden on the AMCs.

A comprehensive structure of a mutual fund appears as depicted in the chart below:



(Source: www.lastbull.com)

So in the diagram, we see the Sponsor, the Trustees, the AMC, the Mutual Fund, its Transfer Agent and Custodian, and last but not least, the Unit Holders. All of these industry participants function within the regulations laid down by the SEBI. This brings us to our next question.

What is a mutual fund?

A mutual fund is a legal vehicle that enables a collective group of individuals to:

i. Pool their surplus funds and collectively invest in instruments / assets for a common investment objective.
ii. Optimize the knowledge and experience of a fund manager, a capacity that individually they may not have
iii. Benefit from the economies of scale which size enables and is not available on an individual basis.

Investing in a mutual fund is like an investment made by a collective. An individual as a single investor is likely to have lesser amount of money at disposal than say, a group of friends put together.

Now, let's assume that this group of individuals is a novice in investing and so the group turns over the pooled funds to an expert to make their money work for them. This is what a professional Asset Management Company does for mutual funds. The AMC invests the investors' money on their behalf into various assets towards a common investment objective.

Hence, technically speaking, a mutual fund is an investment vehicle which pools investors' money and invests the same for and on behalf of investors, into stocks, bonds, money market instruments and other assets. The money is received by the AMC with a promise that it will be invested in a particular manner by a professional manager (commonly known as fund managers). The fund managers are expected to honour this promise. The SEBI and the Board of Trustees ensure that this actually happens.

The organisation that manages the investments is the Asset Management Company (AMC). The AMC employs various employees in different roles who are responsible for servicing and managing investments.

The AMC offers various products (schemes/funds), which are structured in a manner to benefit and suit the requirement of investors'. Every scheme has a portfolio statement, revenue account and balance sheet.

The chart below shows the typical classification of mutual fund schemes on various basis:

Basis	Type of funds/schemes					
	1	2	3	4	5	6
Tenor	Open Ended	Close Ended	-	-	-	-
Asset Class	Equity	Debt/ Income	Hybrid	Real Assets	-	-
Investment Philosophy	Diversified Equity	Sector	Index Funds	Exchange Traded Funds (ETFs)	Fund of Funds (FOF)	Fixed Maturity Plans (FMPs)
Geographic Regions	Country/ Regions	Offshore	-	-	-	-

(Source: Personal FN Research)

• Tenor

Tenor refers to the 'time'. Mutual funds can be classified on the basis of time as under;

1. Open ended funds

These funds are available for subscription throughout the year. These funds do not have a fixed maturity. Investors have the flexibility to buy or sell any part of their investment at any time, at the prevailing price (Net Asset Value - NAV) at that time.

2. Close Ended funds

These funds begin with a fixed corpus and operate for a fixed duration. These funds are open for subscription only during a specified period. When the period terminates, investors can redeem their units at the prevailing NAV.

• Asset classes

1. Equity funds

These funds invest in shares. These funds may invest money in growth stocks, momentum stocks, value stocks or income stocks depending on the investment objective of the fund.

2. Debt funds or Income funds

These funds invest money in bonds and money market instruments. These funds may invest into long-term and/or short-term maturity bonds.

3. Hybrid funds

These funds invest in a mix of both equity and debt. In order to retain their equity status for tax purposes, they generally invest at least 65% of their assets in equities and roughly 35% in debt instruments, failing which they will be classified as debt oriented schemes and be taxed accordingly. (Please see our Tax Section on Page 34 for more information.) Monthly Income Plans (MIPs) fall within the category of hybrid funds. MIPs invest up to 25% into equities and the balance into debt.

4. Real asset funds

These funds invest in physical assets such as gold, platinum, silver, oil, commodities and real estate. Gold Exchange Traded Funds (ETFs) and Real Estate Investment Trusts (REITs) fall within the category of real asset funds.

• Investment Philosophy

1. Diversified Equity Funds

These funds diversify the equity component of their Asset Under Management (AUM), across various sectors. Such funds avoid taking sectoral bets i.e. investing more of their assets towards a particular sector such as oil & gas, construction, metals etc. Thus, they use the diversification strategy to reduce their overall portfolio risk.

2. Sector Funds

These funds are expected to invest predominantly in a specific sector. For instance, a banking fund will invest only in banking stocks. Generally, such funds invest 65% of their total assets in a respective sector.

3. Index Funds

These funds seek to have a position which replicates the index, say BSE Sensex or NSE Nifty. They maintain an investment portfolio that replicates the composition of the chosen index, thus following a passive style of investing.

4. Exchange Traded Funds (ETFs)

These funds are open-ended funds which are traded on the exchange (BSE / NSE). These funds are benchmarked against the stock exchange index. For example, funds traded on the NSE are benchmarked against the Nifty. The Benchmark Nifty BeES is an example of an ETF which links to the stocks in the Nifty. Unlike an index fund where the units are traded at the day's NAV, in ETFs (since they are traded on the exchange) the price keeps on changing during the trading hours of the exchange. If you as an investor want to buy or sell ETF units, you can do so by placing orders with your broker, who will in-turn offer a two-way real time quote at all times. The AMC does not offer sale and re-purchase for the units. Today, ETFs are available for pre-specified indices. We also have Gold ETFs. Silver ETFs are not yet available.

5. Fund of Funds (FOF)

These funds invest their money in other funds of the same mutual fund house or other mutual fund houses. They are not allowed to invest in any other FOF and they are not entitled to invest their assets other than in mutual fund schemes/funds, except to such an extent where the fund requires liquidity to meet its redemption requirements, as disclosed in the offer document of the FOF scheme.

6. Fixed Maturity Plan (FMP)

These funds are basically income/debt schemes like Bonds, Debentures and Money market instruments. They give a fixed return over a period of time. FMPs are similar to close ended schemes which are open only for a fixed period of time during the initial offer. However, unlike closed ended schemes where your money is locked for a particular period, FMPs give you an option to exit. Remember though, that this is subject to an exit load as per the funds regulations. FMPs, if listed on the exchange, provide you with an opportunity to liquidate by selling your units at the prevailing price on the exchange. FMPs are launched in the form of series, having different maturity profiles. The maturity period varies from 3 months to one year.

• Geographic Regions

1. Country or Region Funds

These funds invest in securities (equity and/or debt) of a specific country or region with an underlying belief that the chosen country or region is expected to deliver superior performance, which in turn will be favourable for the securities of that country. The returns on country fund are affected not only by the performance of the market where they are invested, but also by changes in the currency exchange rates.

2. Offshore Funds

These funds mobilise money from investors for the purpose of investment within as well as outside their home country.

So we have seen that funds can be categorised based on tenor, investment philosophy, asset class, or geographic region. Now, let’s get down to simplifying some jargon with the help of a few definitions, before getting into understanding the nitty-gritty of investing in mutual funds.

DEFINITIONS

- ### Net Asset Value (NAV)

NAV is the sum total of all the assets of the mutual fund (at market price) less the liabilities (fund manager fees, audit fees, registration fees among others); divide this by the number of units and you arrive at the NAV per unit of the mutual fund.

Simply put, this is the price at which you can buy / sell units in a mutual fund.

- ### Standard Deviation (SD)

SD is the measure of risk taken by, or volatility borne by, the mutual fund. Mathematically speaking, SD tells us how much the values have deviated from the mean (average) of the values. SD measures by how much the investor could diverge from the average return either upwards or downwards. It highlights the element of risk associated with the fund. The SD is calculated by using returns of the scheme i.e. Net Asset Value (NAV).

- ### Sharpe Ratio (SR)

SR is a measure developed to calculate risk-adjusted returns. It measures how much return you can expect over and above a certain risk-free rate (for example, the bank deposit rate), for every unit of risk (i.e. Standard Deviation) of the scheme. Statistically, the Sharpe Ratio is the difference between the annualised return (Ri) and the risk-free return (Rf) divided by the Standard Deviation (SD) during the specified period. Sharpe Ratio = (Ri-Rf)/SD. Higher the magnitude of the Sharpe Ratio, higher is the performance rating of the scheme.

- ### Compounded Annual Growth Rate (CAGR)

It means the year-over-year growth rate of an investment over a specified period of time. Mathematically it is calculated as under:

$$\text{CAGR} = \left(\frac{\text{Ending Value}}{\text{Beginning Value}}\right)^{\left(\frac{1}{\text{\# of years}}\right)} - 1$$

- **Absolute Returns**

These are the simple returns, i.e. the returns that an asset achieves, from the day of its purchase to the day of its sale, regardless of how much time has elapsed in between. This measure looks at the appreciation or depreciation that an asset - usually a stock or a mutual fund - achieves over the given period of time. Mathematically it is calculated as under:

$$\frac{\text{Ending Value} - \text{Beginning Value x 100}}{\text{Beginning Value}}$$

Generally returns for a period less than 1 year are expressed in an absolute form.

Now that we have covered what is a mutual fund, and the various types of mutual funds that exist, there is one more matter to address before we move forward and get into some detail, and that is:

Why should we invest in mutual funds?

While everyone fantasizes about investing in the stock markets and is passionate about investing in stocks, what's more important is; how smartly are these investments done.

One can invest in the stock markets either through the direct route i.e. stocks or through the indirect route i.e. mutual funds.

Both have their own pros and cons, and so it's important for us to understand both routes before embarking on an investment spree.

If an investor has a profound insight into stocks and investments with the requisite time and skill to analyze companies, then he can surely begin independent stock-picking. However, if an investor lacks any one or all these pre-requisites, then he's better off investing in stocks through the indirect route i.e. through mutual funds. Mutual funds offer several important advantages over direct stock-picking.

1. Diversification

Investing in stocks directly has one serious drawback - lack of diversification. By putting your money into just a few stocks, you can subject yourself to considerable risk. Decline in a single stock can have an adverse impact on your investments, damaging the returns of your portfolio.

A mutual fund, by investing in several stocks, tries to overcome the risk of investing in just 3-4 stocks. By holding say, 15 stocks, the fund avoids the danger of one rotten apple spoiling the whole portfolio. Funds own anywhere from a couple of dozen to more than a hundred stocks. A diversified portfolio may thus fall to a lesser extent, even if a few stocks fall dramatically. Also, a mutual fund's NAV may certainly drop, but mutual funds tend to not fall as freely or as easily as stocks. The legal structure and stringent regulations that bind a mutual fund do a very good job of safeguarding investor interest.

2. Professional management

Active portfolio management requires not only sound investment sense, but also considerable time and skill.

By investing in a mutual fund, you as an investor do not have to track the prospects and potential of the companies in the mutual fund portfolio. This is already being done for you, by skilled research professionals appointed by the mutual fund houses, professionals whose job it is to continuously research and monitor these companies.

3. Lower entry level

There are very few quality stocks today that investors can buy with ₹ 5,000 in hand. This is especially true when valuations are expensive. Sometimes, with as much as ₹ 5,000 you can buy just a single stock. In the case of mutual funds, the minimum investment amount requirement is as low as ₹ 500. This is especially encouraging for investors who start small and at the same time take exposure to the fund's portfolio of 20-30 stocks.

4. Economies of scale

By buying a handful of stocks, the stock investors lose out on economies of scale. This directly impacts the profitability of portfolio. If investors buy or sell actively, the impact on profitability would be that much higher.

On the other hand, in case of mutual funds, frequent voluminous purchases/sales results in proportionately lower trading costs than individuals thus translating into significantly better investment performance.

5. Innovative plans/services for investors

By investing in the stock market directly, investors deprive themselves of various innovative plans offered by fund houses.

For example, mutual funds offer automatic re-investment plans, systematic investment plans (SIPs), systematic withdrawal plans (SWPs), asset allocation plans, triggers etc., tools that enable you to efficiently manage your portfolio from a financial planning perspective too.

These features allow you to enter/exit funds, or switch from one fund to another, seamlessly - something that will probably never be possible in case of stocks.

6. Liquidity

A stock investor may not always find the liquidity in a stock to the extent they may want.

There could be days when the stock is hitting an upper/lower circuit, thus curtailing buying/selling. Further, if an investor is invested in a penny stock, he may find it difficult to get out of it.

On the other hand, mutual funds offer some much required liquidity while investing. In case of an open-ended fund, you can buy/sell at that day's NAV by simply approaching the fund house directly, or by approaching your mutual fund distributor or even by transacting online. (See our section on How to Invest for more details)

As highlighted above, investing in mutual funds has some unique benefits that may not be available to stock investors. However by no means are we insinuating that mutual fund investing is the only way of clocking growth. This can also be done even by investing directly into the right stocks. However, mutual funds offer the investor a relatively safer and surer way of picking growth minus the hassle and stress that has become synonymous with stocks over the years.

On account of the aforementioned advantages which mutual funds offer, they (mutual funds) have emerged as immensely popular asset class, especially for retail investor, and for the investor looking for growth with lower risks.

We can consider placing the tax snippet here as an advantage and bring in DTC mention as a potential advantage lost

Debunking MF investing myths

Very often, we see that mutual fund investors are surrounded by myths based on widely held, yet incorrect beliefs and also based on flawed information. Both these kinds of myths can consequently lead investors to make incorrect investment decisions. We'd like to take this opportunity to debunk some common mutual fund myths:

Myths based on Incorrect Beliefs

When asked why the avid investor of stocks/shares does not take to mutual funds with the same passion and enthusiasm, the likely response is that mutual funds investments are dull and boring. They lack the thrill that one gets by investing in stocks. Bringing us to Myth # 1:

1. Mutual funds lack excitement

"Who wants to invest in a staid investment like a mutual fund that probably grows half as fast as some 'exciting' stocks like Infosys, ONGC or BHEL during a bull run? The poser is relevant. Underperformance almost always gets the thumbs down, no matter what the reason. After all, every investor wants his money to work for him and if a stock does that better, why invest in a mutual fund?"

Yes, stocks can be exciting. And mutual funds may lack the excitement of a stock, but it's the kind of excitement that investors can do without for their long-term wealth as well as health. Mutual funds may not give an impetus to the investor's portfolio in a bull run like some 'exciting' stocks. But, you can be sure that they won't burn a huge crater in the investor's portfolio either. Something that could be inevitable, should individual stocks be crashing by say 40%.

2. **Mutual funds are too diversified**

"Mutual funds own too many stocks to be of any serious benefit. A focused portfolio of 8-10 stocks will generate a more attractive return than a mutual fund portfolio comprising 30-40 stocks."

We are not sure if there is any theory to prove or disprove that concentrated portfolios (8-10 stocks) do better than diversified portfolios (30-40 stocks) in the Indian context. Of course, Mr. Warren Buffet has successfully managed a small portfolio over a long period of time. But, not too many investors can claim to have his investment discipline, insight and experience. In the absence of these important traits, it would be incorrect to expect a concentrated portfolio to outperform a diversified portfolio, at least over the long-term (3-5 years).

Remember, fund managers are experienced money managers and their mandate is to outperform the benchmark index of the fund. And if these experienced managers have chosen the diversification route that tells us a little about how to go about making money in the stock markets.

3. **Mutual funds are too expensive**

"Mutual funds aren't cheap. On an average, the recurring expenses for a diversified equity fund ranges from 2.25% to 2.50% of net assets."

The 2.50% (maximum) recurring expenses charged by the mutual fund go towards meeting the brokerage costs, custodial costs and fund management cost. These are expenses that stock investors incur as well (barring the fund manager's salary). Consider this, when you have a competent fund manager who combines his time, effort and expertise to research stocks and sectors to pick his best 30-40 stocks and also buys and sells them for you, you have someone who is doing a lot of work for you and is charging only a maximum of 2.50% of your investments. Of course we agree that this must be followed by sheer out performance of the benchmark index and even peers. You don't want to pay for underperformance.

The good news is that quite a few diversified equity funds have managed to put in what can be termed as 'a very good performance' over 3-5 years vis-à-vis the benchmark index and peers. Which are these funds, you ask?

TOP 10 DIVERSIFIED EQUITY FUNDS

Scheme Name	6-Mth (%)	1-Yr (%)	3-Yr (%)	5-Yr (%)	Since Incep.
IDFC Premier Equity-A (G)	27.0	46.7	21.1	28.4	28.4
Birla SL Dividend Yield Plus (G)	25.8	40.5	20.9	20.8	33.7
ING Dividend Yield (G)	25.2	43.9	20.5	-	20.3
ICICI Pru Discovery (G)	18.5	38.2	19.6	21.2	30.5
Reliance Reg Savings Equity (G)	16.5	29.8	19.5	27.1	25.4
UTI Dividend Yield (G)	20.1	34.9	17.9	23.3	25.3
HDFC Equity (G)	25.8	40.0	17.5	26.1	24.0
HDFC Top 200 (G)	22.3	30.9	16.9	26.3	24.7
UTI Master Value (D)	24.1	44.1	16.7	17.7	24.8
Quantum LT Equity (G)	23.2	39.1	16.6	-	20.6
BSE SENSEX	14.1	17.2	5.1	18.4	0.0
S&P CNX Nifty	14.6	18.6	6.3	18.3	0.0

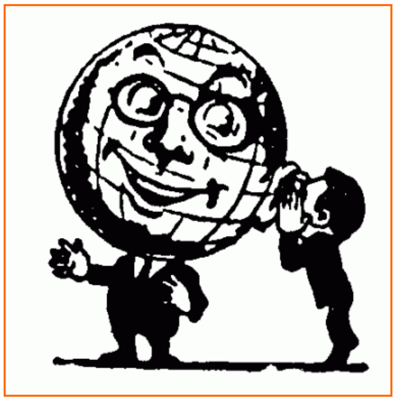
Performance as on Sept 30, 2010

(Source: ACE MF)

Note: *Personal* FN does not recommend that the reader transact in any mutual funds without doing the necessary research. The aforementioned table does not represent the recommendation of *Personal* FN. Readers are requested to consult their advisors / financial planners before investing.

In sum, we'd like to say that investing your money is serious business, which is best done with a methodical approach. Mutual funds allow for that, and investors must try to benefit from them. At the end of the day, being a successful investor is all about making the most prudent investment decisions, even if they are dull and boring.

Myths based on Incorrect Facts



1. Equity funds invest up to 35% in debt

Equity funds are commonly known to take on the investment mandate (mentioned in the fund scheme offer document) to invest up to 35% of their assets in debt and money market instruments. This in turn, leads investors to believe that the fund manager intends to use asset allocation as a strategy for delivering growth i.e. investors expect the fund to capitalise on opportunities from both the equity and debt markets.

However in reality, most equity funds rarely use the mandate to invest in debt. In other words, the intention is to be a 'true blue' equity fund that is almost entirely invested in equity instruments at all times.

Equity funds invest a smaller portion (if at all) of their corpus in debt with the intention of curbing losses in a falling equity market. Clearly, benefiting from investment opportunities in the debt markets, by being invested therein at all times is not the intent. Investors who intended to invest in an 'asset allocation' kind of fund are likely to be disappointed by their equity fund.

The learning: *Investors looking to invest in 'asset allocation' funds should consider investing in hybrid funds (usually 65% in equities and balance in debt) or Monthly Income Plans – MIPs (usually about 20% in equities and balance in debt).*

2. Funds with more stars/higher rankings make better buys

Often, investors make their investment decisions based on the fund's ranking or the number of stars allotted to it. Fund rankings and ratings have gained popularity over the years; a higher ranking/rating is construed as a sign of the fund being a good investment avenue.

Sadly, what investors fail to realise is that often rankings/ratings are based only on the past performance on the net asset value (NAV) appreciation front. Very few rankings/ratings in the market consider factors such as volatility and risk-adjusted performance. So the fund's NAV might have grown over the years, but with a very high risk factor.

Secondly, rankings/ratings are known to change over a period of time in line with a change in the fund's performance. Does that mean investors should start buying and selling a fund in line with a change in its ranking/rating? More importantly, fund rankings/ratings operate on the rationale that one-size-fits-all. They fail to reveal who should invest in the fund. For example, if an aggressively managed sector fund notches the highest ranking based on performance, will it make an apt fit in a risk-averse investor's portfolio?

The answer is - ***Clearly not! The fund rankings and ratings do not convey this to the investor.***

The learning: *At best, rankings and ratings can serve as starting points for identifying a broader set of "investment-worthy" funds. But investing in a fund based solely on its ranking/rating would be inappropriate.*

Instead, investors should engage the services of a qualified and experienced financial planner who can help in selecting funds that are right for them. Remember to choose a financial planner who is fee based, which ensures that they will be unbiased and work in your interests.

3. Once a fund house makes the grade, so do all its funds

"One swallow does not a summer make" goes the proverb. Similarly, just because a fund house makes the grade, it doesn't necessarily mean that all its funds are worth investing in. Typically, for a fund house to make the grade, it should be governed by a process-driven investment approach. Also, it must have a track record of delivering and safeguarding investors' interests at all times.

Investors often make the mistake of confusing the fund for its fund house i.e. they assume that simply because a fund belongs to a given fund house, it's worth investing in. Such an investment approach is far from correct. It is not uncommon to find funds (from quality fund houses) that have either lost focus on account of persistent change in positioning or have fallen out of favour with the fund house itself, on account of their lacklustre investment themes.

The result of the neglect (on the fund house's part) is visible in the fund's performance. Despite being exposed to the best investment processes, such funds fail to deliver.

The learning: *While the importance of the fund house is indisputable, the same shouldn't be seen as certification for every fund it offers. After passing muster at the fund house level, each fund must also prove its own worth, in terms of its investment proposition and track record across parameters.*

4. A fund invests in the same stocks as its benchmark index

A number of investors believe that a mutual fund always invests in the same stocks that constitute its benchmark index. For example, if the BSE Sensex is the benchmark index for a fund, then it is expected to invest in the same 30 stocks that form the BSE Sensex. This is true only in the case of index funds i.e. passively-managed funds that attempt to mirror the performance of a chosen index. In all other cases, i.e. in actively managed funds, the fund manager is free to invest in stocks from within the index and without.

The benchmark index only serves the stated purpose i.e. benchmarking. It offers investors the opportunity to evaluate the fund's performance. Generally, a fund's success is measured in its ability to outperform its benchmark index. Secondly, the benchmark index also aids in 'broadly' understanding the kind of investments the fund will make. For example, a fund benchmarked with BSE Sensex or BSE 100 would typically be a large cap-oriented fund, while one benchmarked with S&P CNX Midcap is likely to be a mid cap-oriented fund.

The learning: *Don't expect an actively managed fund to invest in the same stocks as its benchmark index. While the benchmark index can prove handy in evaluating the fund's performance, it certainly need not form the fund's investment universe.*

5. The dividend option is better

While investing in a mutual fund, investors can choose between the growth and the dividend options; furthermore, within the dividend option, they can select either the dividend payout (wherein the dividend is paid to the investor) or the dividend reinvestment (wherein the dividend is used to buy further units in the fund, thereby increasing the number of units held by the investor) options. But, our experience says that investors usually opt in for the dividend payout option.

A common misconception is that opting for the dividend option is better, since it provides better returns on account of dividends declared. This is so because investors feel that they fetch better dividend adjusted returns, as compared to the returns in the growth option.

But is this true? Given below is a table which explains that if an investor invests ₹ 10,000 in the HDFC Top 200 Fund on Jan 07, 2000 in the dividend and the growth option each, at an NAV of ₹ 25.81 & ₹ 25.04 respectively, and stays invested for a period of little over 10 years; his returns on his investments would be only 17.9% under the dividend option and 22.7% under the growth option.

This thus indicates that opting for a dividend option does not always give better returns, when compared to growth option.

It also noteworthy that the rate of dividend declared by the fund house is calculated on the face value of the units. For example when a 25% dividend is declared by the fund, it means the investor will get ₹ 2.50 [₹ 10 (F.V.) x 25%] per unit.

	HDFC Top 200 (D)			HDFC Top 200 (G)	
NAV Date	NAV (₹)	Dividend %	Cash Flow	NAV (₹)	Cash Flow
07-Jan-2000	25.81		-10000	25.04	-10000
24-Mar-2000	24.81	25	969	24.90	-
25-Aug-2000	16.03	21	814	16.03	-
23-Feb-2001	13.84	20	775	15.87	-
15-Mar-2002	12.44	20	775	16.46	-
31-Oct-2003	19.90	25	969	33.20	-
08-Mar-2004	21.96	15	581	41.92	-
15-Dec-2004	24.07	30	1162	49.35	-
17-Feb-2006	36.31	45	1744	85.04	-
07-Feb-2007	42.97	50	1937	114.81	-
07-Feb-2008	48.13	50	1937	145.51	-
05-Mar-2009	23.36	30	1162	78.87	-
11-Mar-2010	46.58	40	1550	180.11	-
30-Sep-2010	53.13		20584	224.76	89762
Returns (CAGR)			**17.9%**		**22.7%**

(Source: ACE MF)

NAV and Performance as on Sept. 30, 2010

The learning: *Don't select the dividend option assuming that it will offer better returns. Instead, the investor's need for liquidity and his investment objective should play a role in deciding which option is chosen. Ideally investors who are looking out for a regular income should consider a dividend option, whereas those who are not in requirement of regular income should go in for the growth option.*

Invest in the mutual fund, not its NAV

NFOs (New Fund Offers) launched at an issue price of ₹ 10 are perceived to be a good investment opportunity by a large section of mutual fund investors. Similarly, existing mutual funds with a lower NAV (Net Asset Value) often appeal more to investors. We believe that that neither of the approaches to selecting a mutual fund is right. In this note, we revisit our views on investing based on the NAV.

Mathematically NAV is expressed as:

$$*NAV = \frac{\text{Total of all assets – less liabilities (other than to unitholders)}}{\text{Total number of outstanding units}}$$

* Always expressed per scheme

An illustration should help to understand better how the NAV is calculated:

NAV calculation

Total Assets (in ₹)	71,000
Liabilities (in ₹)	1,000
No. of Units	5,000
NAV (in ₹)	14

So, when an investor invests in a mutual fund, he invests at its existing NAV. The investor buys the units at a price (i.e. NAV), the calculation of which is based on the current market price of all the assets that the mutual fund owns. In other words, the NAV represents the fund's intrinsic worth.

In case of the stock market investing however, the stock price of a company is usually different from its intrinsic worth, or what is called the book value of the share. The stock price could be higher (premium) or lower (discount) as compared to the book value of the company. A relatively lower share price would, other things being positive, make it an attractive purchase (as the share seems undervalued).

The reason for such a 'mis-pricing' could be that investors evaluate the company's future profitability and suitably pay a higher or lower price as compared to its book value. This does not hold true for open-ended mutual funds – they always, always, trade at their book value; so investors never buy them cheap or expensive in that sense.

The following illustration will clearly establish the irrelevance of NAV while making an investment decision.

NAV: Does it matter?

Open-ended large cap equity funds	NAV (₹)	1-Yr (%)
HDFC Top 200 (G)	224.76	30.9
Franklin India Prima Plus (G)	233.99	30.0
Franklin India Bluechip (G)	224.53	29.2
ICICI Pru Power (G)	121.69	28.3
Principal Large Cap (G)	30.65	28.1
SBI Magnum Equity (D)	35.04	27.2
ICICI Pru Target Returns (G)	14.98	26.4

(Source: ACE MF)

NAV and Performance as on Sept. 30, 2010.

HDFC Top 200 Fund, with an NAV of ₹ 224.76 (second highest NAV in our sample) has topped on the 1-Yr return front, by clocking a return of 30.9%. On the other hand, Franklin India Prima plus Fund which tops on the NAV front (₹ 233.99) has clocked a return of 30.0%.

Hence, it clearly indicates that there is no correlation between the NAV and the performance of the mutual fund. This makes an investment decision based on the NAV potentially misguiding. As an investor, you need to consider factors such as your own risk profile, the fund house's management style and the mutual fund's performance.

1. Risk profile

Investors have a risk profile that dictates how much risk they can take on to achieve their investment objective. In this backdrop, they must identify mutual funds that can help them meet their investment objectives at the desired risk level. For instance, some equity funds adhere to the growth style of investment (aggressively managed funds); while others follow the value style of investment (conservatively managed funds). So, it is important for investors to select a fund that takes on risk in line with their own risk appetite.

2. Fund management style

Fund houses have varying fund management styles and processes. Some pursue the individualistic style, where the fund manager has his own style of investing, rather than the preset investment process fixed by the mutual fund house.

As opposed to this, there are mutual fund houses that pursue a team-based investment approach where the investment process holds influence over the individual. Our preference is for the team-based style of investing, since it is more stable and the mutual fund (and its investors) is not over-dependent on an individual.

3. Mutual fund performance

It is imperative for investors to evaluate a mutual fund on parameters related to risk like Standard Deviation and Sharpe Ratio as also its NAV appreciation. The risk parameters evaluate the volatility in performance (Standard Deviation) and returns generated by the fund per unit of risk borne (Sharpe Ratio). The best deal for an investor will come from a mutual fund that has higher NAV appreciation and Sharpe Ratio and lower Standard Deviation.

We believe that, hopefully we have resolved the debate on the NAV and have given you more relevant points to inquire about before considering investing in a mutual fund. So, the next time your mutual fund distributor advances the low NAV or ₹ 10 NAV arguments, demand a detailed analysis of the mutual fund based on the parameters we have listed.

Past performance is not everything

The eternal disclaimer: As an investor in mutual funds, you are expected to go through the fact sheet and offer document and read the disclaimer (below the scheme's historical returns) stating, "past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments".

SEBI has made it mandatory for fund houses to state this disclaimer explicitly, whenever they mention the past performance of a scheme. This guideline was made mandatory by the regulator since fund houses were mis-selling their schemes based on the past performance, presenting it as 'the most' important parameter.

But, despite these disclaimers, investors do continue to get lured by the catchy advertisement which boasts about the scheme's past performance.

We at *Personal* FN believe that past performance is not something to get lured by. This is because past performance of a particular scheme simply informs you, the investor, how much return the mutual fund scheme has generated over a time frame.

But there are certain critical points that the past performance numbers in isolation do not tell you. We discuss these points below:

1. The **risk the investor has been exposed to** in the mutual fund's quest for growth is not represented by the NAV. In a rising market, it is not altogether difficult to clock higher growth if the fund manager is willing to take on higher risk (we have seen this on several occasions like the tech rally in 1999-early 2000, the mid cap rally in 2003-05). In that case, the past performance numbers in isolation will be inaccurate because they do not give you any indication of the higher risk you have been exposed to.

   We believe that before making any investment, it must be evaluated based on the risk-return criterion; evaluating the investment option across any one of the two i.e. risk or return on a stand-alone basis will not provide the necessary assessment. You may ultimately end up investing in an avenue that is not completely suited to your needs.

2. Another reason why past performance is not entirely representative of a mutual fund's 'good showing' is because; it **does not take into consideration the performance of its peers.** It is possible that a fund has performed reasonably well (across relevant parameters) by itself, but hasn't quite made the mark when compared to its peers.

   You should compare an investment (be it a mutual fund, fixed deposit, unit-linked insurance plan – ULIP, among others) with its comparable peer group while assessing whether or not you should invest in it.

3. Past performance **fails to highlight the investment processes and approach** pursued by the fund house. It does not tell you whether the past performance is the result of:

   i) good fortune/luck

   ii) a star fund manager

   iii) a team-based investment approach that takes decisions based on well-defined processes rather than being dependent on a particular individual (like the star fund manager)

   At *Personal* FN, we place considerable importance on Point iii) the team based investment approach. Unfortunately, the marketing campaign adopted by fund houses by way of the literature they print doesn't help us with that information, this is something that can be learned only after constant interaction with fund houses and their investment teams. **Past performance often ignores the change in investment mandate.** Fund houses first talk of a star fund manager who was instrumental in sprucing up their performance. They get a lot of money based on this star fund manager. The performance numbers that are advertised are attributed to the 'brilliance' of the star fund manager.

   Say the star fund manager quits (which in many cases is often a matter of time), the fund house continues to use the performance attributable to the ex-fund manager to draw fresh monies under the new (star) fund manager! You however, may not be informed of whether the performance being advertised is the result of the existing team or an older team.

On the same lines, **a mutual fund that revises its mandate/investment objective** but continues to use the performance figures under the older mandate/investment objective. Again, you as an investor have absolutely no idea whether the performance numbers correspond to the revised mandate or an older mandate.

4. Of course, last but not the least, **past performance is no guarantee of future performance**. While this is adequately mentioned in the advertisements, we wonder why it needs to be advertised in the first place. It's a bit like advertising tobacco products freely with a small disclaimer on tobacco possibly causing cancer written in fine print at the bottom of the packet!!

Don't time your mutual fund investments - Take a SIP

Very often, investors tend to time the market. You know it's true. We all want to buy at the lows and sell at the highs. And yes, ideally one should enter the market when it is at lower levels and exit when it is at higher levels.

But, to do so is almost impossible. No one can predict where the markets are heading tomorrow. Nonetheless, when individuals get news or tips from brokers/friends/relatives or such other 'informed' sources, investments are made.

Tips and news can be the resort for the short-term investor. But, for serious investors, who are investing for a longer duration (3-5 years) for a broader financial planning objective (like planning for your child's education, retirement planning), a "tip" is not the way to go.

Additionally, and unfortunately, many long-term investors before investing in equity funds wait for the markets to decline in order to invest at lower levels.

We believe that you should invest regularly for the purpose of meeting your long-term investment objectives. An effective and a hassle-free way of investing regularly is through the SIP (Systematic Investment Plan) route.

With SIPs, you don't have to worry about timing the market since you are investing a fixed amount at regular intervals (like a month or quarter, for instance). If markets correct, the option to invest any surplus funds to get a lower average cost is always available.

4 good reasons for investing regularly through SIPs:

1. Light on the wallet

Given that the average annual per capita income of an Indian citizen is approximately only ₹ 25,000 (i.e. monthly income of ₹ 2,083), a ₹ 5,000 one-time entry in a mutual fund may still appear high (2.4 times the monthly income!). And, mutual funds were never meant to be elitist; far from it, in fact the retail investor is as much a part of the mutual fund target audience as the next high net worth investor (HNI). So, if an investor cannot invest ₹ 5,000 in one shot, that's not a huge stumbling block, the investor can simply take the SIP route and trigger the mutual fund investment with as low as ₹ 250 per month.

2. Makes market timing irrelevant

If market lows give you the jitters and make you wish you had never invested in equity, then SIPs can help. Plenty of retail investors are not experts on stocks and are even more out-of-sorts with stock market oscillations.

But, that does not necessarily make stocks a loss-making investment proposition. Studies have repeatedly highlighted the ability of stocks to outperform other asset classes (debt, gold, even property) over the long-term (at least 5 years) as also to effectively counter inflation. So, if stocks are such a great thing, why are so many investors complaining? It's because they either got the stock wrong or the timing wrong. Both these problems can be solved through an SIP in a mutual fund with a steady track record.

3. Power of compounding

The early bird gets the worm is not just jungle folklore. The same stands true for the 'early' investor, who gets the lion's share of the investment booty vis-à-vis the investor who comes in later (see table below). This is mainly due to a thumb rule of finance called 'compounding'.

Particulars	Vijay	Ajay	Sanjay
Present age (years)	25	30	35
Retirement age (years)	60	60	60
Investment tenure (years)	35	30	25
Monthly investment (₹)	7,000	7,000	7,000
Returns per annum	10%	10%	10%
Sum accumulated (₹)	26,576,466	15,823,415	9,287,834

(Source: Personal FN Research)

So as we see, Vijay starts at age 25, and invests ₹ 7,000 per month until retirement (age 60). Hiscorpus at retirement is approximately ₹ 2.65 crore. Ajay starts at age 30, a mere 5 years after Vijay, and invests the same amount until retirement (also at age 60). His corpus comes to approximately ₹ 1.58 crore, note the difference between the 2 corpuses here.

And lastly, we have Sanjay, the latest bloomer of the lot. He begins investing at age 35, the same amount monthly as Vijay and Ajay, and invests up to his retirement (also at age 60). His corpus is, in comparison, a meagre ₹ 92 lakhs.

So the earlier you begin your SIPs, the better off you are thanks to compounding.

4. Lowers the average cost

SIPs work better as opposed to one-time investing. This is because of rupee-cost averaging. Under rupee-cost averaging, an investor typically buys more of a mutual fund unit when prices are low.

On the other hand, he will buy fewer mutual fund units when prices are high. This is a good discipline since it forces the investor to commit cash at market lows, when other investors around him are wary and exiting the market. Investors who kept their SIPs going while the Sensex fell from 21,000 to 8,000 in 2008 and sitting on some significant profits now, because they kept up their investing discipline.

SIP Returns

Scheme Name	1-Yr SIP Returns (%)	2-Yr SIP Returns (%)	3-Yr SIP Returns (%)
HDFC TOP 200 (G)	44.9	59.0	35.6
Franklin India Bluechip (G)	38.6	51.2	29.8
Birla SL Frontline Equity -A (G)	34.5	50.9	29.8
Franklin India Prima Plus (G)	40.1	48.9	27.9
Baroda Pioneer Growth (G)	31.0	47.3	27.3
DSPBR Top 100 Equity - Reg (G)	33.7	44.6	26.5
IDFC Imperial Equity - A (G)	28.7	39.3	23.5
Average	**35.9**	**48.8**	**28.7**

(Source: *Personal* FN Research)

Performance as on Sept. 30, 2010

The above table explains the absolute returns generated by SIPs in the respective time frame. For investment in some large cap funds, SIPs on an average have delivered absolute returns of 35.9%, 48.8% and 28.7% over 1-yr, 2-yr and 3-yr periods.

Taxation and on your mutual fund investments

One key point to keep in mind when investing, is how that investment is going to be taxed. Given below are the facts you need to know regarding taxation of mutual funds:

Equity Funds

- As an investor if you have opted for the dividend option, for the reason that you want cash inflows to be managed through dividends, then the **dividends** which you received under the scheme is completely exempt from tax under section 10(35) of the Income Tax Act, 1961.

- If you are caught in the wrong habit of short-term (period of less than 12 months) trading, then you better be ready to forgo your profits/capital gains, if any, in the form of **Short Term Capital Gains (STCG) tax.** STCG are subject to taxation @ 15% plus a 3% education cess.

- If an investor deploys his money for long-term (over a period of 12 months) and thus subscribe to a good habit of long-term investing, then there is no tax liability towards **any Long Term Capital Gain (LTCG)**

- If an investor deploys his money in an **Equity Linked Saving Scheme (ELSS),** then he **enjoys a tax deduction under section 80C of the Income Tax Act,** which enables him to reduce his Gross Total Income (GTI). However, this benefit can be availed by investors upto a maximum sum of ₹ 1,00,000. Also **at the time of exiting** (after 3 years of lock-in) from the fund the investor will **not be liable to any LTCG tax**

- Investors will also have to **bear a Securities Transaction Tax (STT) @ 0. 25%;** this is levied at the time of redemption of mutual fund units.

Debt Funds

- Similarly, in a debt funds too, if investors have opted for the dividend option, to manage your cash inflows, then the dividend which the scheme declares will be subject to an additional tax on income distributed. Hence, in such a case investors are actually paying the tax indirectly.

- Unlike equity funds, in debt funds, investors are liable to pay a tax on their **Long Term Capital Gains (LTCG),** which is 10% without the benefit of indexation and 20% with the benefit of indexation.

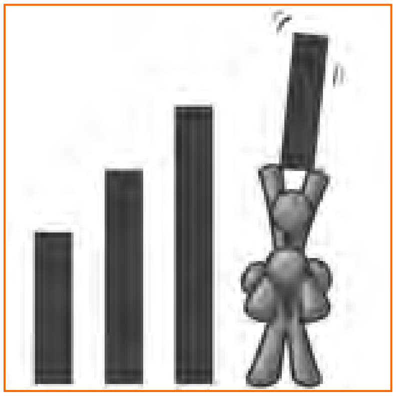
- Similarly, in case of **Short Term Capital Gains (STCG),** the individual assesses will be taxed at the rate, in accordance to the tax slabs

Unlike in case of equity mutual funds, investors will not have pay any **Securities Transaction Tax (STT)**

So now that we know what to watch out for and the basic Do's and Don'ts, we come to how to actually select a winning mutual fund.

How to select a mutual fund

The increased number of New Fund Offerings (NFOs) lately has led also to an increased dilemma in



the mind of investors. Investors often get confused when it comes to selecting the right fund from the plethora of funds available. Many investors also feel that 'any' mutual fund can help them achieve their desired goals. But the fact is, not all mutual funds are same. There are various aspects within a fund that an investor must carefully consider before short-listing it for making investments. These aspects which were briefly covered in the Path to Knowledge section, are given in a little more detail below:

- **Performance**

The past performance of a fund is important in analysing a mutual fund. But, as learnt earlier past performance is not everything. It just indicates the fund's ability to clock returns across market conditions. And, if the fund has a well-established track record, the likelihood of it performing well in the future is higher than a fund which has not performed well.

Under the performance criteria, we must make a note of the following:

1. **Comparisons**: A fund's performance in isolation does not indicate anything. Hence, it becomes crucial to compare the fund with its benchmark index and its peers, so as to deduce a meaningful inference. Again, one must be careful while selecting the peers for comparison. For instance, it doesn't make sense comparing the performance of a mid-cap fund to that of a large-cap. Remember: Don't compare apples with oranges.

2. **Time period**: It's very important that investors have a long term (atleast 3-5 years) horizon if they wish to invest in equity oriented funds. So, it becomes important for them to evaluate the long term performance of the funds. However this does not imply that the short term performance should be ignored. Besides, it is equally important to evaluate how a fund has

performed over different market cycles (especially during the downturn). During a rally it is easy for a fund to deliver above-average returns; but the true measure of its performance is when it posts higher returns than its benchmark and peers during the downturn. Remember: Choose a fund like you choose a spouse – one that will stand by you in sickness and in health.

3. **Returns**: Returns are obviously one of the important parameters that one must look at while evaluating a fund. But remember, although it is one of the most important, it is not the only parameter. Many investors simply invest in a fund because it has given higher returns. In our opinion, such an approach for making investments is incomplete. In addition to the returns, investors must also look at the risk parameters, which explain how much risk the fund has taken to clock higher returns.

4. **Risk**: We have seen in our Definitions section and on our Path to Knowledge, that risk is normally measured by Standard Deviation (SD). SD signifies the degree of risk the fund has exposed its investors to. From an investor's perspective, evaluating a fund on risk parameters is important because it will help to check whether the fund's risk profile is in line with their risk profile or not. For example, if two funds have delivered similar returns, then a prudent investor will invest in the fund which has taken less risk i.e. the fund that has a lower SD.

5. **Risk-adjusted return**: This is normally measured by Sharpe Ratio. It signifies how much return a fund has delivered vis-à-vis the risk taken. Higher the Sharpe Ratio, better is the fund's performance. From an investor's perspective, it is important because they should choose a fund which has delivered higher risk-adjusted returns. In fact, this ratio tells us whether the high returns of a fund are attributed to good investment decisions, or to higher risk.

6. **Portfolio Concentration**: Funds that have a high concentration in particular stocks or sectors tend to be very risky and volatile. Hence, investors should invest in these funds only if they have a high risk appetite. Ideally, a well diversified fund should hold no more than 40% of its assets in

its top 10 stock holdings. Remember: Make sure your fund does not put all its eggs in one basket.

7. **Portfolio Turnover**: The portfolio turnover rate measures the frequency with which stocks are bought and sold. Higher the turnover rate, higher the volatility. The fund might not be able to compensate the investors adequately for the higher risk taken. Remember: Invest in funds with a low turnover rate if you want lower volatility.

- **Fund Management**

The performance of a mutual fund scheme is largely linked to the fund manager and his team. Hence, it's important that the team managing the fund should have considerable experience in dealing with market ups and downs. As mentioned earlier, investors should avoid fund's that owe their performance to a 'star' fund manager. Simply because if the fund manager is present today, he might quit tomorrow, and hence the fund will be unable to deliver its 'star' performance without its 'star' fund manager. Therefore, the focus should be on the fund houses that are strong in their systems and processes. Remember: Fund houses should be process-driven and not 'star' fund-manager driven.

- **Costs**

If two funds are similar in most contexts, it might not be worth buying the high cost fund if it is only marginally better than the other. Simply put, there is no reason for an AMC to incur higher costs, other than its desire to have higher margins.

The two main costs incurred are:

1. **Expense Ratio**: Annual expenses involved in running the mutual fund include administrative costs, management salary, overheads etc. Expense Ratio is the percentage of assets that go towards these expenses. Every time the fund manager churns his portfolio, he pays a brokerage

fee, which is ultimately borne by investors in the form of an Expense Ratio. Remember: Higher churning not only leads to higher risk, but also higher cost to the investor.

2. **Exit Load**: Due to SEBI's recent ban on entry loads, investors now have only exit loads to worry about. An exit load is charged to investors when they sell units of a mutual fund within a particular tenure; most funds charge if the units are sold within a year from date of purchase. As exit load is a fraction of the NAV, it eats into your investment value. Remember: Invest in a fund with a low expense ratio and stay invested in it for a longer duration.

Among the factors listed above, while few can be easily gauged by investors, there are others on which information is not widely available in public domain. This makes analysis of a fund difficult for investors and this is where the importance of a mutual fund advisor comes into play.

At *Personal* FN, we spend a lot of time and effort in short-listing funds which are best for investors, by using various qualitative and quantitative techniques.

How to build a mutual fund portfolio

At *Personal* FN, we are often flooded with queries from investors on how to go about building a portfolio that will involve minimal tracking and churning and can help them achieve their investment objectives over the long-term.

Building a mutual fund portfolio is not a very simple task since many of these funds seem to be saying (as dictated by the investment objective) and doing (in terms of investments) totally different things. Also with plethora of funds the task gets further difficult.

For the benefit of investors, we have split this process of building a mutual fund into two steps. The first step, outlined below, is relatively easy as it involves eliminating the mutual fund schemes that should not be a part of your portfolio, and second step on the process of selecting a mutual fund.

Step 1: Process of elimination

You should not invest in a mutual fund only because it is recommended by a mutual fund agent. You must also question the existence of every mutual fund in your portfolio so that you are left only with the very best funds. Also, it's important for you to guard against over-diversification. Your fund manager (if he is smart) is taking care of the diversification. There is little point in diversifying something that is already diversified.

While eliminating mutual funds, one has to keep in mind the following points:

1. Refrain from investing in a sector/thematic mutual fund, since over the long-term there is little value that a restrictive and narrow theme can bring to the table. Also, thematic or sectoral funds have a tendency of plunging more during the downturn. Hence, it's best to opt for a broad investment mandate that is best championed by well-diversified equity funds.

2. If there are two or more mutual funds that seem to be doing the same thing (in terms of mandate, style), then you have to ensure that you are left with just the best in that category and eliminate the rest. Do a peer comparison.

3. Finally, evaluate a funds performance over the long-term (3-5 years) and over a market cycles. This enables you to understand whether the equity fund under review has stood the test of time. Many NFOs launched over the last 2-3 years i.e. from 2008 till date, have done reasonably well, leading investors to believe they are well-managed funds. But, remember, the markets have appreciated sharply over this period. So, a fund manager would have to be quite incompetent to have lost money over this period. It takes a bear phase to separate the men from the boys.

Step 2: Process of selection

Once the elimination process is performed by the investors diligently enough, the second step will come naturally. For instance, if you have ignored all the sector/thematic funds, that leaves you with just the well-diversified ones. Likewise, if even those funds that have not completed a 3-Yr track record, you are automatically left with those who have a minimum 3-Yr track record. While selecting mutual funds, you must keep the following points in mind:

1. Investors should have a mix of both large cap as well as mid cap funds, since both have their inherent strengths. When both are well-selected, they can reward the investor handsomely over the long-term. The proportion of investments in large cap funds will depend upon the risk appetite of the investor. For example, a 25-year old person would have a higher allocation towards to mid cap funds, when compared to a large cap fund.

   Similarly, it also pays to invest in an equity fund that can invest in both large caps and mid caps depending on the opportunity; these funds are commonly referred to as opportunities/flexi cap funds.

2. Investors should go for both – well-managed growth style and value style equity funds. This will help to capitalise on opportunities across the board. Growth funds invest in well-managed companies that are fairly valued with a view that they are likely to perform even better going forward. Value funds invest in well-managed companies that are undervalued (temporarily) with the view that they will achieve their fair value going forward.

3. Investing in a balanced fund will help in bringing in stability in the portfolio on account of the provision in the investment mandate for investment in debt.

4. To top it all, the selection process must purely be based on research and analysis. Your agent, neighbours and colleagues are welcome to air their views, but remember at the end of the day it's your money, not theirs.

A lot of what we have said in terms of the research process may appear a little difficult and time-consuming to the investor. That is not surprising, after all investing is a full-time activity and if you give it part-time attention, the results can be disastrous. That is why it is important to engage the services of a competent and experienced financial planner who can help you build a mutual fund portfolio on the lines we have recommended.

How mutual funds can be used for financial planning

"This time, like all other times, is a very good time, if we but know what to do with it."

- Ralph Waldo Emerson

Financial Planning couldn't have been summed up better; to put it simply it allows an investor to know today what is required for achieving financial goals tomorrow.

A financial plan helps an investor in the following ways:

1. Enabling investors to identify his goals and investment needs

2. Understand the various financial products with respect to their risk, return, liquidity and maturity profile

3. Combine the features of financial products with the investor's financial needs and determine appropriate mix of investments, technically referred to as asset allocation

4. Suggest suitable instruments as part of asset allocation

Mutual fund allows a financial planner (read investor) to enhance the effectiveness of his financial plan in the following fashion:

1. Diversification

Diversification as practiced in financial planning can be done at three levels by assets, investment style and management style.

a. Diversification of assets – Assets can be diversified on many levels for example holding a mix of stocks, bonds and cash. Possibly then by geographic sector taking advantage of global opportunities and the fact that if one economy is weak, another is strong. And then by economic sector, to include a variety of industries, because when one industry is slowing down, another is picking up. Each of these diversifications will serve to increase returns and reduce risk.

b. Diversification of styles - Each asset class is then diversified into multiple investment styles - such as growth, value, and opportunities.

c. Diversification of managers - Portfolio returns can be enhanced by using multiple managers with complementary investment styles who react in their own ways to varying market conditions. However, we opine investors not to provide primacy to the fund managers in the diversification criteria.

Asset Allocation

Except for the most conservative portfolios which do not hold equities, every portfolio should be diversified to hold all major assets classes:

a. Cash for security and liquidity, so that one can take advantage of opportunities as they arise
b. Bonds, to help preserve capital and provide a steady income
c. Stocks, for growth to help you beat inflation and counter the impact of taxes
d. Real estate, because of their low correlation with stocks and bonds
e. Gold, for its ability to be a hedge against uncertainties

An important inference could be, that one should spend considerable amount of time and energy in choosing a tailor made or customized asset allocation strategy. Once the strategy is in place, then the next important action point would be the instruments to fulfil the role of respective asset classes.

2. Portfolio Strategy

Most portfolios are structured with 5 financial objectives in mind:

a. Growth
b. Income
c. Inflation protection
d. Peace of mind and preservation of capital
e. Minimize taxes

A financial planner has to balance the importance of each of these, and keep them in mind as he goes about structuring a portfolio. There is no such thing as an optimal balance that's right for everyone. The balance is a personal choice depending on the relative importance of these factors for a given investor. While doing financial planning through mutual funds, one must try to answer the following questions.

a. Towards what objective/goal is the investor allocating his money

Knowing the objective of investing enables the investor to select the right options offered by a mutual fund house. For example, if an individual has a long term objective, then he may go in for a long term equity fund and for investors with short term objectives or needing intermediate returns, a liquid fund is the right option.

b. What is the time horizon?

Time horizon refers to, when does the investor want to enjoy the fruit of investment? This ascertainment is critical because both, the risk and the reward of investments can vary according to the time horizon. Generally, a longer horizon allows for more aggression in investment. The less time, the more one needs to avoid risk.

c. What is the risk tolerance of the investor?

There is a risk-reward continuum running from cash to bonds to stocks. Returns are commensurate with the risk someone is willing to tolerate. Risk has other dimensions investor to replace capital. If not earning any income, replacing lost capital will be difficult, which means a more conservative approach. Other considerations could be the present financial situation, estate planning and level of taxation. One other important factor is age. As a general rule, the younger one is, the more aggressive someone can afford to be with their investment portfolio. This is because the investor has more time to recover from any possible setbacks in the value of the portfolio.

3. Rebalancing

Rebalancing is the action of bringing a portfolio of investments that has deviated away from target asset allocation. The goal of rebalancing is to move the current asset allocation back in line to the originally planned asset allocation. Rebalancing is primarily warranted under conditions where the returns have significantly deviated than expected or to stay in line with market conditions. For example, an equity heavy portfolio needs to be restructured in contraction phases where company profits are hit harder and interest rates move up. It could be done by moving a portion of equity holdings to debt instruments. Mutual funds probably allow the easiest window to rebalancing due to their diversity of offerings.

A case would be help to understand better on rebalancing.

Mr X has planned for his son's marriage in 2020, for which the estimated cost in 2020 would be ₹1.7 crores. In 2010 he is advised to invest ₹70,000 in equity and ₹30,000 in Debt assuming an average return of 12% for equity and 5% for debt the expected value of investments at year end would be 78,400 for equity and 31,500 for debt. At year end, at 8%, the equity markets performed worse than expected and at 14% the debt markets performed better than expected. Hence, the portfolio value, instead of the planned ₹ 109,900 ended up as ₹ 109,800. Consequently, the ratio of debt to equity changed from the original 70:30 to 69:31. To rebalance the portfolio, Mr X has to liquidate his debt holdings by ₹ 2,700 and invest in equity and also add ₹ 100 cash from his own personal reserves.

4. Tax efficiency

Where mutual funds score head and shoulder over other instruments in a financial planner's eyes is when it comes to tax efficiency and reduction in transaction charges. Imagine a scenario where a person holds the individual stocks BSE-Sensex in the same proportion as it is meant to be and another person holds a unit of an index fund. The chances are that the Mutual Fund unit holder would be a happier person for the fact that:

a. The mutual fund unit holder is safe from transaction fees the stockholder might have to pay for using his DEMAT account for equity trading

b. The incidence of capital gains tax would be zero for a mutual fund holder as it is the fund which is involved in equity trading and that equity trading is considered primary business and hence is exempt

c. Dividends declared by equity-oriented funds (i.e. mutual funds with more than 65% of assets in equities) are tax-free in the hands of investor. There is also no dividend distribution tax applicable on these funds under section 115R. Diversified equity funds, sector funds, balanced funds are examples of equity-oriented funds.

Thus, mutual funds allow the financial planner to align the investment goals on the mantra of

DIVERSIFICATION + PATIENCE = SUCCESS

To invest prudently in a mutual fund, one can taking into the account the following 10 pointers for the concluding quick read.

10 pointers to investing in mutual funds

While investing in mutual funds, an investor must primarily broadly look at the following 10 points, which enable them to select the right one:

1. A fund sponsor with integrity

Investors must check the sponsor's (promoter) record in the financial services arena. Apart from a consistent and clean record in financial services, sponsor(s) should have requisite experience and background in managing mutual funds be it in India or overseas.

2. An experienced fund manager

The fund manager must be experienced, which is best reflected in the returns he has generated on funds previously/currently managed by him.

3. A suitable investment philosophy

Every fund manager has his own individual style and investment philosophy. While some managers are aggressive, others are passive. Investors must choose the fund that best reflects and matches his own investment philosophy.

4. The correct fund by nature

Funds are either open-ended or close-ended.

- **Open-ended funds**

  An open-end fund is available for subscription throughout the year. Investors have the flexibility to buy or sell any part of their investment at any time at a price linked to the funds NAV.

- **Close-ended funds**

  A close-end fund begins with a fixed corpus and operates for a fixed duration. The fund is open for subscription only during a specified period. When the period terminates, investors can redeem their units. Close-ended funds may be listed on the stock exchanges to impart liquidity to the investment.

5. The correct fund category

Mutual funds offer different categories. These can be classified as:

- **Debt funds**

  They seek to provide a regular source of income by investing in fixed income securities like debentures and bonds.

- **Equity funds**

  They aim to grow money over time (i.e. capital appreciation). Here, the investment focus is mainly on stocks/shares. Historically, stocks have outperformed other asset classes like bonds, fixed deposits, gold, and real estate over the long term - 10 years.

- **Balanced funds**

  The fund attempts to maintain a balance between fixed income securities and equities in a pre-determined ratio like 60:40 equity - debt for instance.

The investor must invest in mutual fund categories, which meet his criteria in terms of need for regular income, capital appreciation, and safety of principal.

6. Fees and charges

Asset management companies (AMC) charge a fee for managing investor monies. In other words, your mutual fund deducts charges and fees from the net asset value (NAV) of the fund. As an investor you must be aware of the fees and charges of the AMC. Two schemes with more or less similar performances would generate different returns if one of the two schemes charges higher fees.

7. The load

An investor may be required to pay a load either at the time of selling the units. Again, the returns of two similar performing schemes may vary depending on the load charged by the scheme to the investor.

8. The tax implications

The investor needs to understand the tax implications before investing in mutual fund schemes. Currently, if an investors exits (sells) his equity oriented fund prior to the completion of 12 months of his holding period, he will be liable to pay a short-term capital gains tax @ 15% + 3% education cess. However where an investor exits (sells) his equity oriented fund after the completion of 12 months of is holding period, he will not be liable to the payment of long-term capital gains tax. The dividend earned on a equity oriented is also exempt from tax.

Tax-saving funds (commonly known as Equity Linked Saving Schemes (ELSS)) offer a tax benefit to the investors under section 80C of the Income Tax Act 1961, where an investor is eligible for a deduction for sum upto ₹ 100,000.

9. Investor service and transparency

Services offered by mutual funds (MFs) may vary across funds. Some MFs are more investor friendly than others, and offer information at regular intervals. For instance, some funds disclose the expense ratios, an important criterion for fund selection, once a year, some disclose it once every 3 months, while a few disclose it every month.

10. Fund performance

Every fund is benchmarked against an index like the BSE Sensex, Nifty, BSE 100, BSE 200, CNX 500, etc. The investor must track the fund's performance against the benchmark index. He must also compare its performance with other funds from the same category. He should also see the fund's calendar year performances over the years.

So how does one invest in mutual funds?

Mutual funds as an investment product were traditionally sold by mutual fund distributors for commission (which is embedded in the entry load) which was received by them from the mutual fund houses. However, after the abolition of entry load in August 2009, many distributors have stopped selling mutual funds on account of a lack of incentive.

SEBI has recently proposed the fee based model to be adopted by mutual fund distributors. Under this model, a distributor would be paid directly by his clients for the advice provided by him and/or the service. This model is now incorporated, with the intention of making distributors more responsible and accountable.

Investors can transact in mutual funds either through:

- Their mutual fund distributor
- Directly by approaching the AMC
- Through an online mutual fund trading platform

Personal FN offers both the online and offline options for investing in mutual funds, for more information contact your nearest *Personal* FN branch.

Are you protected as a mutual fund investor?

Yes, a mutual fund investor's interest is very much protected by SEBI. SEBI, the market regulator under the SEBI (Mutual Fund Regulation) Act, 1996 carefully dictates the guidelines for mutual funds in India. For an organisation to start a mutual fund business, requires the approval of SEBI. Thus there is quality and credibility check on everyone who enters the mutual fund business.

Some of the Rights and Obligations of investors are:

- In case of dividend declaration, investors have a right to receive the dividend within 30 days of declaration. In case the investor fails to claim the redemption proceeds immediately, then the applicable NAV depends upon when the investor claims the redemption proceeds.

- On redemption request by investors, the AMC must dispatch the redemption proceeds within 10 working days of the request. In case the AMC fails to do so, it has to pay an interest @ 15%. This rate may change from time to time subject to regulations.

- Investors can obtain relevant information from the trustees and inspect documents like trust deed, investment management agreement, annual reports, offer documents, etc. They must receive audited annual reports within 6 months from the financial year end.

- Investors can wind up a scheme or even terminate the AMC if unit holders representing 75% of scheme's assets pass a resolution to that respect.

- Investors have a right to be informed about changes in the fundamental attributes of a scheme. Fundamental attributes include type of scheme, investment objectives and policies and terms of issue.

- Lastly, investors can approach the investor relations officer for grievance redressal. In case the investor does not get an appropriate solution, he can approach the investor grievance cell of SEBI. The investor can also sue the trustees.

In the recent years (2009 & 2010) SEBI brought in some sweeping reforms in the mutual fund industry, which we believe are pro-investor. Some of the reforms were:

- In order to facilitate transferability of units of mutual funds from one demat account to another, SEBI has decided that all AMCs shall allow such transfer of units not later than October 1, 2010. However, restrictions on transfer of units of ELSS schemes during the lock-in-period shall continue to be applicable as per the ELSS guidelines.

- SEBI has directed MF houses to provide investors a chance to exit from a mutual fund scheme, if the methodology to compute the total expenses (charged from an investor) is changed. This directive has been enforced to keep a check on the practice of MFs pampering their agents and distributors with lavish incentives like cash payouts and foreign junkets, in return for higher sales, which is ultimately passed on to the investors.

- AMFI has asked the mutual fund houses to release commission to distributors on a case-by-case basis depending on whether the investor-related documents have been submitted by distributors. The investor-related documents need to be submitted by November 15, 2010.

- **Online mutual fund trading platform was launched by the exchanges (BSE and NSE)**, making transacting in mutual funds easy and convenient for distributors. And now SEBI wants all mutual fund schemes to be listed on the exchanges so that they (exchanges can be used as efficient couriers of orders).

- SEBI has barred mutual funds from selling options contract with effect from October 1, 2010 without specifying any reason. However, for hedging reasons the regulator has allowed them to enter into plain vanilla interest-rate swaps.

- **SEBI ordered mutual funds not to disclose the indicative portfolio or indicative yield of their newly launched Fixed Maturity Plans (FMPs),** since this was pro-actively used as a tool to miss-sell the product to the investors

- **Abolition of entry load** – making mutual fund investing cost effective. However, the mutual fund houses felt a contrarian impact of this ruling, primarily due to the abolition of the commission oriented sales culture. Many distributors too abandoned the selling of mutual funds and started focusing on distribution of insurance products or other fixed deposit products which earned them a higher commission for every sale.

- **SEBI also stepped in to provide mutual fund investors transparency, by making distributors disclose commissions (upfront and trail) to the investor.** This enabled investors to judge the quality of advice and the service provided by the distributor, and accordingly pay the distributor for the advice and service rendered.

- **SEBI allowed mutual fund investors to change their mutual fund distributors without obtaining a No Objection Certificate (NOC) from their earlier distributor**, thus facilitating investors to shift their distributor without any hassle.

Year 2010 for the Mutual Fund Industry

The year 2010, we believe, would continue to bring in reforms in the mutual fund industry, making every initiative pro-investor. Also, many new players are likely to enter the mutual fund space, thus leading to an increase in the product offering to mutual fund investors. The potential for growth will come from inherent strengths and sustained interest by foreign and domestic funds as well as the common investor.

However, the challenges will come from maintaining the interest of the all the participants in the market. Increasing Assets Under Management (AUM) will also be a major challenge, since there is no incentive for the distributors to promote mutual funds. Also after April 1, 2012, when the Direct Tax Code (DTC), come into effect, mutual fund companies and investors would be very watchful on the tax implications of various mutual funds.

But we believe that the overall long term economic outlook for India seems bullish and therefore; investors should consider mutual fund investing for wealth creation.

Interesting reading – Articles on *Personal* FN

- ## Twinkle twinkle little star, how I wonder what you are?

What comes to your mind when you hear this? Yes you are right - the good old days of kindergarten. But here we are not reiterating the good old nursery rhyme which we all learnt in school.

We would like to tell you that in the recent times, giving "star ratings" to a fund has been the latest trend adopted by many mutual fund research houses / rating agencies, in an effort to help investors to pick the "right" mutual funds. But, have you as an investor really questioned or researched yourself as to how these ratings are done? Never. You simply have blind faith and follow the norm that more "stars" there are on the scorecard, better is the fund's performance. Well, that logic may sound good during our school days when a 5 star for our homework, connoted that we were good students.

But, please recognise that evaluating a mutual fund's performance is far different!

Read more…

http://www.personalfn.com/knowledge-center/mutual-funds/views-on-news/10-10-01/twinkle_twinkle_little_star_how_i_wonder_what_you_are.aspx

- ## Monthly Income Plans

In Hybrid funds invest in a mix of both equity and debt instruments. These hybrid funds are further classified as equity oriented hybrid funds and debt oriented hybrid funds on the basis of the proportion of its allocation into equity and debt.

Read more…

http://www.personalfn.com/knowledge-center/mutual-funds/tutorials/10-07-15/monthly_income_plans.aspx

- ## Index funds Vs. Diversified Equity Funds

In terms of fund management style, mutual funds can be broadly classified into two categories, namely actively managed funds and passively managed funds. While the latter is content at giving index-linked returns, the former consciously tries to outperform the benchmark index. In an attempt to outperform the index, the fund manger uses his skills and expertise to select stocks across market sectors and market segments, spends time and effort to research, carry fundamental and technical analysis etc.

Read more…

http://www.personalfn.com/Member-Area-paid/my-subscriptions/Fund-Watch-Details.aspx?FWID=b2184ad1-794e-476e-a68a-c2af51506035

• Fund of Funds – A smart way of investing in mutual funds

Fund of Funds offer investors a unique and excellent investment proposition. These are mutual fund schemes that invest in the schemes of other mutual funds. That means; it takes the concept of mutual fund investing to another level. While mutual funds invest in stocks of various companies, FoFs invests in the schemes of their own fund house or a third party fund house. Now let us understand what makes FoFs a smart way of investing in mutual funds.

Read more...

http://www.personalfn.com/knowledge-center/FullStory/09-06-23/Fund_of_Funds_-_A_smart_way_of_investing_in_mutual_funds.aspx

• Is the dividend option in an NFO a smarter choice?

What's better – the dividend option or the growth option? That's one question, which investors regularly pose to us. In the case of an equity fund, so long as both the options have the same portfolio, they are at par (on rare occasions, some funds have different portfolios for the growth and dividend options). Hence, investors should make their choice based solely on their need for liquidity. Despite dividends not being assured, if liquidity is critical for the investor, he should opt for the dividend option; else, the growth option should be the preferred choice. While the growth option offers compounding benefits, the dividend option offers liquidity.

Read more...

http://www.personalfn.com/knowledge-center/FullStory/08-03-20/Is_the_dividend_option_in_an_NFO_a_smarter_choice.aspx

• All you need to know about ETFs

Thanks to the launch of a number of gold ETFs (exchange traded funds) in the recent past, ETFs as investment avenues have gained a fair bit of popularity as well. Increasingly, ETFs are finding themselves on the investor's 'to invest' list. Having said that, ETFs still have a lot of catching up to do, before they can compete with conventional mutual funds, in terms of popularity among investors. One of the primary reasons for this is lack of knowledge and objective understanding about ETFs among investors. In this article, we present a primer on ETFs and discuss their investment proposition.

Read more...

http://www.personalfn.com/knowledge-center/FullStory/08-08-16/All_you_need_to_know_about_ETFs.aspx

• Want to hedge inflation?

The recent Monetary Policy released by RBI laid its thrust on controlling the spiralling inflation.

Read more...

http://www.personalfn.com/knowledge-center/mutual-funds/views-on-news/10-02-03/want_to_hedge_inflation.aspx

- ## Why sudden positive correlation between gold and equity?

As the global economy is revealing a gloomy picture, the foreigners (FIIs) are betting on the India story, but at the same time being cautious about the health of the global economy they are investing in the safe haven – gold.

http://www.personalfn.com/knowledge-center/gold/views-on-news/10-09-24/why_sudden_positive_correlation_between_gold_and_equity.aspx

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