Subject	**COMMERCE**
Paper No and Title	**16: FINANCIAL MARKETS AND INSTITUTIONS**
Module No and Title	**20: MUTUAL FUNDS: TYPES OF MUTUAL FUNDS**
Module Tag	**COM_P16_M20**

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1. Learning Outcomes

After studying this module, you shall be able to

- Understand the meaning, characteristics and advantages of mutual funds
- Learn about different types of mutual fund schemes based on functional and geographical classification
- Identify the mutual fund schemes based on portfolio and other miscellaneous classifications

2. Introduction

Investors investing in securities market desires to earn maximum return for a given level of risk. But they do not have expertise or they are not professionally qualified to undertake investment analysis. Also sometimes there investment amount is so small that the investment analysis is not worthwhile. In such a case investors can go for indirect investment instead of investing directly. An indirect form of investing in securities market is mutual fund.

3. Mutual funds

3.1 Meaning of mutual fund

Mutual fund is a single, large, and professionally managed investment organization that pools the savings of individual investors and after making proper study of the market and the companies invest it in corporate securities. The returns generated out of such investments after charging the fees of portfolio managers are distributed among the investors.

The securities and exchange board of India defines a mutual fund as “a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.

A mutual fund serves as a link between the investors and the securities market by mobilizing the savings from the investors and investing them in the securities market to generate returns.

Mutual funds offers an opportunity to invest in a diversified portfolio in spite of having less funds, service of good research team along with transparency therefore it is a most suitable form of investment for a common man.

3.2 Characteristics of mutual funds

The various features of mutual funds are as follows:

1) Mutual funds is a non- depository or non- banking financial intermediary.

2) Mutual funds mobilizes the savings from the people and invest them in the mix of corporate and government securities.

3) Mutual funds brings a variety of securities within the reach of the most modest investors.

4) Mutual funds create awareness among the urban and rural middle class about the benefits of investment in capital markets.

5) Mutual funds are controlled and regulated by SEBI and are therefore considered to be safe.

6) Mutual fund is an indirect form of investment i.e the investors invest in mutual funds and the mutual fund invest in shares, bonds ,debentures and other securities in the capital market.

7) Mutual fund works as the representatives of the investors.

3.3 Advantages of mutual funds

Mutual funds make the process of savings and investment simple, accessible and affordable. Some of the advantages of mutual funds are as follows:

3.3.1 Professional and expert services

The management of mutual fund is undertaken by professional managers, who have the requisite skills and experience to analyze the performance and prospects of various companies. They provide continuous supervision and analysis, investment consultancy, judicious investment decision, expert, experienced and professional services at very affordable costs. All these are hardly possible for an individual investor.

3.3.2 Portfolio diversification

The investors have limited funds to invest therefore they find it difficult to achieve diversification through direct investment on their own. Mutual funds provide diversification in the selection of portfolio by investing in number of companies across various industries and sectors. This diversification ultimately reduces the riskiness of the investment.

3.3.3 Economies of scale of operations

Mutual funds have more funds to invest therefore the benefit of economies of scale is available to them.

3.3.4 Less transaction cost

As compared with the cost of investing directly in the capital market, investment through mutual funds is less expensive as the benefit of economies of scale ultimately goes to the investors.

3.3.5 Transparency

Mutual funds investment provides transparency to the investors. Every month mutual funds declare their portfolio and with the help of this the investors are able to know where his/her money is being deployed. In case the investors are not happy with the portfolio, they can withdraw their money at a short notice

3.3.6 Flexibility

Mutual funds offer different types of schemes. Investors have the flexibility to make a choice among them or even they have the option to transfer their money from one scheme to other. .

3.3.7 Freedom from housekeeping

After purchasing the units from mutual fund companies an investor should not bother about the various factors that affect the price of the unit like market behavior, safety of the money, liquidity etc. Mutual Fund Company takes care about all these factors.

3.3.8 Liquidity

Mutual fund units are highly liquid. The fund managers sells the securities whenever there is bull operating in the market and on the other hand they buy securities when bear are operating in the market. In any other situation they just hold the securities.

3.3.9 Well regulated

SEBI well regulates the mutual fund companies. This regulation protects the interest of the investors and creates their confidence in the mutual fund industry.

3.3.10 Spread of risk

Mutual fund companies invest the funds collected in diversified securities, by this risk gets spread amongst various investors. And hence in case of any market crash the loss is being shared by all the investors.

3.3.11 Tax benefits

Various tax benefits are now available to the mutual fund investors.

3.3.12 Convenience

As compared to the direct investment, investment through mutual funds is convenient as it reduces paper work, saves time and makes investment easy.

4. Classification of Mutual funds

Mutual funds are classified on various basis such as functional basis, geographical basis, and portfolio basis and on miscellaneous basis which are discussed as follows:

4.1 Functional classification of mutual fund

On functional basis mutual funds are classified into open ended , close ended and interval schemes or funds

4.1.1 Open ended mutual fund schemes

An open ended mutual fund is one that continuously offers to sell and repurchase its units at net assets value. The maturity period of these schemes are not specified. An investor can buy or sell units at NAV which are declared on a daily basis. Thus these funds provide investors a freedom to enter and exit from the scheme at any time during the life of the fund. Since these schemes have perpetual succession and flexible corpus, these schemes provide instant liquidity to the investors. Unlike close ended schemes, these schemes do not have to be listed on the stock exchange rather they are transacted by the mutual fund themselves.

The fluctuation in stock price causes the purchase price and sales price of these funds to change daily. Therefore when there is bearish in the stock market, the NAV of these schemes decreases and the transactions of buying and selling can be done at low price and vice a versa. The corpus of these schemes are not fixed and goes on increasing or decreasing depending upon the redemption and purchase of the units by the investors.

4.1.2 Close ended mutual fund schemes

Close ended mutual fund schemes have a fixed corpus, stipulated maturity period and a specified subscription period. They are like any other company operating in an industry. The investors are allowed to investor in close ended schemes, when it is launched and that too up to the specified date. Once the initial subscription is over, the units of these schemes are listed on the stock exchange. As the units are listed on the stock exchange it provides liquidity to the investors. The shares of close ended schemes are often sells at discount because from the point of view of the investor's close ended schemes are more risky as compared to the open ended schemes. It is worthwhile for an investor to make investment in close ended scheme only when the discount is very high.

4.1.3 Interval schemes

A scheme that combines the features of both the open ended and close ended schemes is called the interval scheme. In this scheme there is predetermined intervals during which the sale or redemption of units are open at the NAV related prices.

4.2 Geographical classification of mutual fund

On the basis of geographical limits, mutual funds are classified as domestic and offshore mutual funds:

4.2.1 Domestic mutual fund

These funds mobilize the savings of the citizens of a country within the country. These funds can invest their corpus only in the securities which are issued and traded in the domestic financial markets. Therefore the market for such funds is limited and confined to the boundaries of a country in which it operates.

4.2.2 Offshore mutual fund

Such funds attract foreign capital for investment purposes in the country of the issuing company. These funds can invest in the securities of a foreign company. Such funds facilitate cross border flow of funds which is a direct route for getting foreign currency without getting political interference. Investors investing in offshore mutual funds can expect high risk and high return. The first offshore Indian mutual fund was launched by unit trust of India in collaboration with US fund manager Merril lynch. Canbank's indo-swiz Himalayan fund 1990 and commonwealth equity funds are example of offshore mutual funds in India.

4.3 Portfolio classification of mutual fund

Here the basis of classification is nature and types of securities and the basic objective of investment. On portfolio basis mutual funds are classified into income fund,

4.3.1 Income fund

The basic aim of income fund is to provide safety of investment and steady income to its subscribers. Therefore such schemes generally invest in fixed income securities like bonds, debentures of companies having good credit rating, government securities and money market instruments. That is why debt fund is the other name given to the income fund. There is less risk as well as less return in income fund as compared to the equity funds. These funds do not provide the advantage of capital appreciation.

4.3.2 Growth fund

The basic aim of growth fund is to provide capital appreciation to its subscribers over a long period of time. Generally such scheme invests their corpus in equity shares of the companies having good growth prospects. Such funds have high risks in comparison to the income funds. In these funds there is no guarantee or assurance of returns. Such funds are good for investors seeking appreciation over a long period of time.

4.3.3 Balanced fund

The aim of balanced fund is to provide capital appreciation and regular income to its subscribers. These funds are an intermediary between income fund and growth fund. Balanced funds make their investment balance by investing in equity shares as well as in debt instruments of good companies. The portfolio of balanced funds comprises of companies having good profit and dividend track record. The risk and return of these funds are moderate. Thus these funds are appropriate for investors looking for moderate growth. In comparison to the pure equity funds the NAV'S of such funds are less volatile. Fluctuations in the share prices in the stock markets also affect the prices of these funds.

4.3.4 Money market fund

The basic aim of such funds is to provide high safety and liquidity with low rate of return. Such fund provides complete safety to the investors but the yields of such funds are not so high. These funds invest in short term money market instruments like treasury bills, commercial papers and certificate of deposits. These funds are open end funds for short term use and are completely safe for the investors.

4.3.5 Tax saving fund

The basic aim of such funds is to offer tax rebates to the investors under various provisions of the income tax act. Generally such funds invest in equities which are growth oriented and also provide various tax incentives. Equity linked saving schemes and pension schemes launched by the mutual funds are example of tax saving funds. These schemes are close ended schemes and investments are made for a long period of time.

4.3.6 Gilt fund

These are the funds which invest their corpus exclusively in the government securities. Since such funds have no default risk, these funds are preferred by investors who are very risk averse in nature. As in case of income and debt funds the NAV of such funds also fluctuate due to change in interest rates and other economic factors.

4.3.7 Fund of funds

Such funds that make their investments in other schemes of the same fund or in other mutual funds are known as fund of funds. Since such funds spread risk, these provide greater diversification to the investors.

4.4 Miscellaneous classification of mutual fund

The other various remaining classifications of mutual funds are as follows:

4.4.1 Index funds

When the investment by the mutual fund is made according to a particular index such as the BSE sensitive index, S&P NSE 50 index such funds are called index funds. The weights of investment in different securities are same as that of the index. The increase or decrease in the index causes the same percentage increase or decrease in the NAV'S of such schemes. Under such fund no extra effort is made by the fund manager to identify the stocks for investment/ dis-investment.

The fund manager merely tracks the index on which it is based. Index funds are very popular outside the India.

4.4.2 Sectoral funds

When the investments are made in specific core sectors like energy, telecommunications, IT, construction and transportation the funds are called the sectoral funds. The performance of the industries determines the returns of these funds. These funds are considered to be high risky as compared to the other diversified funds.

4.4.3 Exchange traded funds

Exchange traded funds are listed on the stock exchanges. They are traded like individual securities on the stock exchanges. Such funds are quite similar to the Index funds. These funds do not sell their shares directly to the retail investors for cash, rather shares are offered to the investors over the stock exchanges. The price of these shares is determined by the demand and supply conditions and the market value of the shares. An example of exchange traded fund is UTI's Sunders listed in Mumbai stock exchange. Exchange traded funds are generally preferred because they are listed in the stock exchanges and also they provides liquidity to the investors. ETF's are basically passively managed funds and their value changes with the value of the index.

4.4.4 Load and no- load funds

Various expenses such as brokerage, marketing expenses and communication expenses are incurred by the mutual funds. These expenses are known as 'load' and are covered by the investors at the time of buying and selling the units. On the other hand the funds that do not charge any load or fees at the time of entry or exit are called no-load funds. All the transactions of sale and repurchase of units are done at NAV in case of no-load funds whereas the repurchase is made at a price less than NAV and sales is made at a price more than NAV in case of load funds. Generally an entry load is charged in case of equity oriented funds while no loads are being charge in case of income fund.

5. Summary

- Investors do not have expertise to undertake investment analysis therefore they go for indirect investment instead of investing directly.
- Mutual fund is a professionally managed organization that pools the savings of individual investors and invest it in corporate securities,
- Mutual fund serves as a link between investors and the securities market.
- Mutual funds provide various advantages like professional and expert services, portfolio diversification, economies of scale of operations, less transaction cost, transparency, flexibility, freedom from housekeeping, liquidity, well regulated, spread of risk, tax benefits and convenience.
- There are four main categories of mutual funds in which it is classified these are functional, geographical, portfolio and miscellaneous classifications.
- Open ended funds continuously offers to sell and repurchase its units at NAV whereas for close ended funds there is fixed corpus, stipulated maturity period and specified subscription period. Interval scheme is a combination of open ended and close ended schemes.
- Domestic mutual funds make their investment in securities that are traded domestically whereas in off shore funds the investment is made in international securities also.
- The basic aim of income fund is to provide safety of investment and steady income to its subscribers whereas for growth fund it is to provide capital appreciation to its subscribers over a long period of time.
- Balanced fund provides both regular income and capital appreciation to its subscribers.
- Money market fund provides high safety and liquidity with low rate of return.
- Tax saving funds provides various tax rebates to its investors.
- The funds that invest their corpus exclusively in government securities are called gilt fund.
- Under fund of fund scheme the investments are made in some other scheme of same fund or in other mutual fund.
- When the investments of a fund are made according to a particular index the fund is called the Index fund.
- In sectoral funds the investments are made in specific core sectors like telecommunications, IT, constructions etc.
- The funds that are listed on stock exchanges are called exchange traded fund.
- The scheme that covers the various mutual fund expenses are called the load funds whereas the fund that does not cover its expenses from the investors are called no- load fund.