A BEGINNER'S GUIDE TO MUTUAL FUNDS

Investing for growth mainly involves investing in equity oriented products

There are two ways in which one can invest money – the conservative way and the aggressive way. The former mainly involves investing in fixed income (debt) instruments as the risk of capital loss is lower. However, the flip side is that returns may or may not be able to beat inflation. On the other hand, the aggressive way is to invest in equity oriented securities which have the potential to not only beat inflation but also provide higher returns in the long run. However, equities carry a higher risk of capital loss in the short run.

Which is the right way to invest - conservative or aggressive? The answer depends on two aspects, one, your appetite for risk and two, your investment horizon. If you are not a risk taker and fear capital loss, you would ideally want to keep cash which is risk-free. However, this is not prudent as prices of all goods and services would appreciate over the short to medium term due to inflation. The conservative way is thus to invest in fixed income securities or debt mutual funds where the risk of capital loss is lower.

Within fixed income securities, one may look at traditional assured returns products or market linked products. The former include bank fixed deposits, government or post office savings like National Savings Certificates or Public Provident Fund, while the latter include tradable bonds and debt mutual funds. The latter do not provide any assurance on returns but are more likely to beat inflation in the short to medium term vis-à-vis traditional products. Fixed income products are also suitable for short to medium investment horizons as they are less volatile.

In the aggressive way of investing, equity is the key. This asset class has historically proven to be among the top return providers in the long run (typically beyond 5 years). Equity by definition provides a share of the profits of an enterprise or business. The returns of an equity portfolio are directly proportionate to the profitability of the businesses (shares) owned in the portfolio. A country’s economy grows mainly because of its enterprise and equity is expected to do well if the economy does well and may hit a trough if the economy is on the down turn. This is known as market cycle. Hence one must invest in equities only if he is a long term investor as market volatility or risk reduces over multiple market cycles.

Within equities, one may look at equity shares and equity mutual funds. One of the best ways to invest in equities is through professionally managed and closely regulated equity mutual funds which offer both variety and convenience. They consist of actively and passively managed funds. Passively managed equity funds provide returns in line with a market index while actively managed funds try to beat the market index. History has proven that equity has the potential not only to beat inflation but also to generate higher returns and create wealth over the long term. However, investors must be aware that equities carry the potential of capital loss in the short run. One also needs to follow two guiding principles while investing in equity - invest regularly and stay invested for the long haul.

SUMMARY

An investor can either adopt the conservative approach or aggressive approach to invest his money. The former involves investment in fixed income instruments and debt mutual funds while the latter includes investing in equity and equity oriented mutual funds. Fixed income investments may or may not beat inflation while equity investments have the potential to not only beat inflation but also generate wealth over the long run. One of the best ways to invest in equities is through equity mutual funds. Investors must be aware that equities carry the potential of capital loss in the short run. One needs to follow two guiding principles while investing in equity - invest regularly and stay invested for the long haul.

NEXT TO COME: EQUITY FUNDS FOR LONG TERM INVESTMENT