WHAT ARE EQUITY FUNDS & BENEFITS OF INVESTING IN EQUITY FUNDS?

Chapter 17

A BEGINNER'S GUIDE TO MUTUAL FUNDS

Equity funds are those mutual funds that primarily invest in stocks. You invest your money in the fund via SIP or lumpsum which then invests it in various equity stocks on your behalf. The consequent gains or losses accrued in the portfolio affect your fund's Net Asset Value (NAV). Of course, there are technicalities involved but this is the crux of investing in equity mutual fund schemes. However, being a prudent long-term investor helps know more details about the functionings of an equity mutual fund. Let us observe them in detail.

What are Equity Mutual Funds?

An equity mutual fund invests largely in the stocks of various companies to generate returns. Equity fund investments are linked to higher risk as compared to other types of mutual funds. Moreover, equity funds are 'not one size fits all'. There are a variety of equity funds classified by their investment objective that need to be mapped to your risk profile.

How do Equity Funds work?

Equity mutual funds invest major corpus in equity shares of various companies in particular proportions. This asset allocation is based on the type of equity fund and its alignment with the investment objective. Depending on the market conditions, the asset allocation can be made purely in stocks of small-cap, mid-cap, or large-cap companies. After allocating a significant proportion to the equity segment, the remaining amount is invested in debt and other money market instruments. This helps bring down the element of risk and take care of sudden redemption requests.

Who should invest in Equity Mutual Funds?

Your decision to invest in mutual funds must be in sync with your investment horizon, risk profile, and other objectives. The same is the case for equity fund investments. If you have a long-term goal, it is advised to invest in equity funds. It will provide your funds the much-needed time to combat market movements and fluctuations.

What are the types of Equity Mutual Funds?

Equity mutual funds can be differentiated based on:

Based on Investment Objective:

Though the objective of all equity funds is generally capital appreciation, it is the risk taken to achieve this objective that varies. This further depends upon the types of stocks that the fund invests in. Some types of equity mutual funds based on their investment objective are:

1. **Small-cap Equity Funds**

These equity mutual fund schemes invest in companies that rank above 250 in terms of their full market capitalization (as per SEBI guidelines). These funds are considered to be riskier than mid- or large-cap equity funds but can offer the relatively higher returns. Their minimum exposure to such stocks is 65% of the total assets.

2. **Mid-cap Equity Funds**

These equity mutual fund schemes invest in companies who rank between 101 and 250 by their full market capitalization. These funds are considered to be less risky than small-cap funds, but more than large-cap funds. Their minimum exposure to such stocks is 65% of the total assets.

3. **Large-cap Equity Funds**

These equity mutual fund schemes invest in companies who rank between 1 and 100 in terms of full market capitalization. These funds are considered to be the least risky as far as equity fund-picking goes. Their minimum exposure to such stocks is 80% of the total assets.

4. **Large- & Mid-cap Equity Funds**

These equity mutual funds equally divide the allocation between large- and mid-cap equity and related instruments and have the potential to offer high returns. The mandated minimum exposure to both large-cap and mid-cap stocks is 35% each of the total assets.

5. **Multi-cap funds**

Multi-cap equity funds invest in stocks across large-, mid-, and, small-cap companies. Depending on the market conditions, the fund manager decides the predominant investments. Their minimum exposure to such stocks is 65% of the total assets.

Based on Investment Strategy:

As an investor, you also need to know the investment strategy followed by the fund house, i.e. the methodology used to select the stocks. The key investment strategies or styles include top-down strategy, bottom-up strategy, value strategy, and growth strategy.

i) Top-down strategy - It means that the sector is chosen first and then the stocks within that sector are purchased in the portfolio.
ii) Bottom-up strategy – It means that well-researched stocks are bought irrespective of the sector.
iii) Growth strategy – It means that the fund will invest in companies that have a consistent track record of profitability and growth and are likely to sustain on this path.
iv) Value strategy – It means that the fund will invest in companies that have the potential to grow exponentially in the future and are currently available at a lower value.

Based on Asset Allocation:

There are a few funds that split the portfolio allocation between predominantly equity (at least 65%) and the rest in debt or between domestic and international equity. It is important to look at asset allocation from a tax-efficiency perspective as per the provisions of the Income Tax Act, 1961. International equity funds that have a predominant foreign equity allocation are classified as debt funds for income tax purposes.

ELSS (Equity linked savings scheme)

Equity-Linked Savings Schemes (ELSS fund) are a tax-saving mutual fund investment scheme that invest predominantly in equity and equity-related schemes. Under this scheme, the corpus of the investment is invested majorly in equity and the rest in debt related securities. An individual can claim up to Rs. 46,800 (assuming the highest slab of income tax i.e. @30% plus education cess 4%) annually by investing in ELSS funds.

How are Equity Funds performing in India?

Among the various categories of mutual funds in India, equity mutual funds generally deliver relatively higher returns.. The returns can fluctuate on factors depending on the overall economic conditions and market movement. To earn returns that are aligned with your expectations, you should choose your equity funds carefully. You should strictly follow the stock markets and possess knowledge of the quantitative and qualitative factors..

What are the benefits of investing in Equity Funds?

There are a lot of benefits of investing in equity mutual funds. Some of them are:

1. Professionally managed: Fund managers are market experts who professionally manage equity funds. These experts study the market, analyze the performance of various companies, and invest in the performing stocks that could deliver optimal returns to the investors.
2. Easy on pocket: An individual can invest in equity funds through the SIP (Systematic Investment Plan) method, wherein she/he can make weekly, bi-weekly, or monthly or quarterly investments as low as Rs. 500. Investing via SIP is a popular method of investing in equity funds as it helps beat the volatility of the equity markets through rupee-cost averaging.
3. Portfolio diversification: Individuals are exposed to various stocks when they invest in an equity mutual fund. Thus, even if some stocks in the portfolio underperform, the individual would be able to achieve capital gains from the performance of the other stocks investments.
4. Liquidity: Units of an equity fund can be redeemed anytime on any business day at the applicable NAVs. This offers liquidity to investors. An exception to this is ELSS funds, wherein an investor cannot liquidate unless the lock-in period, i.e. 3 years, is over.
5. Capital growth Equity funds have the potential to offer considerable returns to beat inflation. Individuals can accrue a substantial amount of wealth over the long-term by investing in equity funds.
6. Tax benefits: Individuals investing in ELSS funds enjoy tax deduction. An individual can invest Rs. 1.5 lakh in ELSS schemes under Section 80C of the

Income Tax Act, 1961, and save up to Rs. 46,800 (assuming the highest slab of income tax i.e. @30% plus education cess 4%) each year, effectively reducing their tax liabilities.

Tax Benefits of Equity Funds

LTCG (long-term capital gains) tax is applicable at 10% on capital gains exceeding Rs. 1 lakh (long term capital gains amount from equity oriented mutual funds/ equity shares) in a year without any indexation benefit. STCG (short-term capital gains) tax of 15% applies to investments in equity funds provided that the seller pays STT (securities transaction tax) of 0.001%. Funds qualify for LTCG if they are held for a duration over 12 months and for STCG if they are held for less than 12 months.

However, ELSS funds differ from regular funds as they have a lock-in period of 3 years. This means that ELSS mutual funds can be redeemed only at the end of this lock-in period. ELSS funds is tax saving option under Section 80C.
Conclusion
Simply put, fund houses pool your money and invest in equity funds after in-depth research. However, it is important to understand the inner workings of equity funds. This includes knowing the objective of the equity fund and mapping it to your risk profile. The next is the fund’s asset allocation followed by the investment strategy. Last, but not least, you also ought to know the expense ratio of the fund as it could impact returns.

Happy Investing!

SUMMARY

Simply put, equity mutual fund schemes pool your money and invest in equity stocks after in-depth research. However, it is important to understand the basics of how equity funds work. This includes knowing the objective of the equity fund and mapping it to your risk profile. Next is the asset allocation of the fund followed by the investment strategy. Last but not the least; you also ought to know the expense ratio of the fund as it could impact returns.

NEXT TO COME: BUILDING A GROWTH PORTFOLIO