

₹ MUTUAL FUND INVESTMENT GUIDE: HOW TO INVEST IN MUTUAL FUND PLANS

Chapter 8

A BEGINNER'S GUIDE TO MUTUAL FUNDS



Mutual fund investments were an unfamiliar form of investment to a large number of Indian investors just a couple of decades ago. But the situation today is quite different. With a steady rise in mutual fund investors in India year after year, mutual funds, today, are viewed as a simple and easy way to invest that could help build wealth.

So, if you are wondering where to begin with mutual funds, here's everything you need to know.

What is a mutual fund

A mutual fund is an investment product that pools money from a group of investors to purchase different securities. However, most people regard a mutual fund as an investment avenue. In reality, you can invest in various financial securities like stocks, bonds, gold and money market instruments through an investment vehicle.

When you buy a unit in a mutual fund, you own a small stake in all the investments included in the fund. Mutual funds can be an ideal investment choice given their ease of use and the advantages they offer.

How do mutual funds work?

A mutual fund is essentially a trust that collects money from several like-minded investors.

Asset Management Companies (AMCs) manage and operate many mutual fund schemes. Each scheme has a specific investment objective catering to distinct investment needs.

Based on the fund's objective, the money collected from investors is placed in various avenues such as stocks, gold, bonds and other securities. A finance professional known as a fund manager whose goal is to earn optimum returns on the fund's investments oversees each fund. The income generated by the fund is divided and distributed among the investors proportionately.

Benefits of investing in mutual funds

1) Professional expertise

When you invest in a mutual fund, a professional fund manager handles your investments. A team of researchers who track the market on a real-time basis supports every fund manager. Based on their inputs, fund managers make necessary changes to your mutual fund portfolio to maximize returns. This option can become a suitable option for salaried people (and business owners) who do not have the time to track markets or make timely investments.

2) Convenience

Investing in mutual funds can be a hassle-free and straightforward exercise. The entire process is paperless, and you can complete it from the comfort of your home. And once you begin your investment journey, you can follow your holdings and make necessary adjustments, if needed, through your computer or smartphone.

3) Begin with small investments

Many people assume you can only invest in mutual funds if you have a large sum of money. In reality, you can begin investing with just Rs. 500 per month. A Systematic Investment Plan ([SIP](#)) can help you invest small amounts regularly. And if your income rises over time, you can also increase your SIP allocation. This way, you not only lower your investment costs but also benefit from the power of compounding.

4) Diversification

Diversifying your portfolio is vital if you are looking to minimize your exposure to risk and loss. An adequately diversified portfolio can weather the poor performance of a single stock or sector, thus cushioning your total investments. Mutual funds are designed in a way to provide adequate diversification.

For instance, a mutual fund that tracks the S&P BSE 100 index could open your investment to as many as 100 securities in a single fund. This can be a simple and cost-effective way of diversifying your portfolio.

5) Tax benefits

Section 80C of the Income Tax Act provides tax deductions on investments made in specific financial instruments. This includes mutual funds too.

Currently, you can claim a tax benefit of up to Rs. 1.5 lakh per year in Equity Linked Saving Scheme (ELSS) that offer one of the shortest lock-in period. These reasons make ELSS funds a popular tax-saving option among investors.

Different types of mutual funds in India

Mutual funds are segregated into different groups. Each fund type aims to achieve definite goals. Here are the common types of mutual funds you can find:

Funds based on asset class:

a) Debt funds

Debt funds (also known as fixed-income funds) invest in assets like government securities, corporate bonds and money market instruments. These funds generally aim to offer regular returns to the investor and are considered relatively stable. Debt funds are ideal if your purpose is to earn a steady income and hesitant to take a huge risk.

b) Equity funds

In contrast, equity funds invest a primary portion of your money in stocks. Capital appreciation is an essential objective for these funds. But since the returns on equity funds are linked to market movements, they hold higher risk. Equity funds can be a right choice for long-term goals – retirement planning or buying a house – due to its risk with the investment spread over a long period of time.

c) Hybrid funds

If you want equity as well as debt in your investment, hybrid funds can be the answer. They invest in a mix of equity and fixed-income securities. Based on their asset allocation, hybrid funds are further classified into six categories:

- Conservative hybrid fund: The scheme invests around 75-90% of assets in debt instruments and just about 10-25% in equity or equity related instruments.
- Balanced hybrid fund: The scheme invests about 40-60% in equity and 40-60% in debt instruments.
- Aggressive hybrid fund: Invests between 65-80% in equities and between 20-35% in debt instruments.
- Dynamic asset allocation fund: Invests both in equity and debt and the fund allocation is managed based on pre-defined market indicators.
- Multi-asset allocation: Invests in at least three asset classes with a minimum allocation of at least 10% each in all three asset classes
- Arbitrage fund: The fund follows an arbitrage strategy and invests a minimum of 65% in equities / equity related instruments.
- Equity savings fund: Invests at least 65% of assets in equity and at least 10% in debt instruments.

Funds based on structure:

a) Open-ended mutual funds

Open-ended funds are mutual funds where an investor can invest at any time. These funds are bought and sold at their Net Asset Value (NAV). Open-ended funds can be a good liquid option as you can purchase and redeem the fund units at any time. Most mutual funds in the market are open-ended funds.

b) Close-ended mutual funds

Close-ended funds come with a pre-defined maturity period. Investors can invest in the fund only when it is launched. And after investing, they can withdraw their money only at the time of maturity. These funds are listed just like shares in the stock market. However, they are not regarded as liquid because trading volumes are less.

c) Interval funds

Interval funds contain features of both close-ended and open-ended funds. These funds don't permit investors to buy or sell units anytime. There are certain pre-decided time periods or intervals during which you can buy and redeem your funds. These funds invest in both debt and equity securities.

Funds based on investment objective:

Mutual funds can also be classified based on investment objectives.

a) Growth funds

The main purpose of growth funds is capital appreciation. These funds put a significant portion of the money in stocks and growth sectors. However, they can be risky; hence, it is recommended to have a long-term horizon when investing in them. And if, for instance, you are nearing your retirement, you could avoid growth funds.

b) Income funds

As the name suggests, income funds try to provide investors with a regular income. These are debt funds that invest in bonds, debentures, commercial papers, government securities and certificate of deposits, among others. They can be a source of income in the short-term for low risk investors. Based on your investment horizon and risk appetite, you can also invest in duration funds. These are open ended debt schemes that invest in debt and money market instruments.

Fund type	Portfolio investment duration
Ultra-short duration fund	between 3-6 months
Low duration fund	between 6 months to 1 year
Short duration fund	between 1-3 years
Medium duration fund	between 3-4 years
Medium to long duration fund	between 4-7 years
Long duration fund	greater than 7 years

c) Liquid funds

Liquid funds aim to provide liquidity to the investor. These funds put money in short-term money-market instruments like treasury bills, Certificate of Deposits (CDs), term deposits, commercial papers, and so on. Liquid funds can be an option if you want to park your surplus money for the short term or create an emergency fund.

Overnight funds are another interesting option you can consider if liquidity is your priority. These are open-ended debt mutual funds that invest in securities having a maturity of just one day. This makes overnight funds highly liquid. These funds come with very low risk as they are not impacted by changes in interest rates. Overnight funds are suitable for those investors who want to park a large sum of money for a short period.

d) Tax-saving funds

Tax-saving funds offer tax benefits in the form of tax rebates under Section 80C of the Income Tax Act. When you invest in these funds, you can claim deductions up to Rs 1.5 lakh each year. Tax-saving funds can be suitable if your primary investment goal is to save tax. Equity Linked Saving Scheme (ELSS) funds are an example of tax-saving funds.

Things to consider as a first-time investor

1) Have an investment goal

When you invest in mutual funds, invest with specific goals in mind. List down your financial goals, budget and the time horizon to achieve these goals. This exercise can help you determine the amount you need to set aside each month towards your investments. Sometimes, you may have to reduce your expenses in other areas to achieve your financial targets. And these calculations can only be possible if you put pen to paper and list your financial goals.

2) Choose the investment profile carefully

There are many mutual fund types and categories – equity funds, debt funds, hybrid funds, among other fund types. Funds are also segregated based on their market capitalization. Choose the fund type carefully to ensure you reach your desired goals. If you are new to investing, it may be a good idea to start with debt funds or hybrid funds to minimize your risk exposure. Subsequently, pick a fund that matches your investment goals and risk profile.

3) Don't focus too much on past returns

Past performance is undoubtedly a crucial factor to consider before investing in a mutual fund. But it need not be the sole criterion. Many new investors invest in a fund based on the past one-year performance that could be a poor strategy. This is because some new and unknown funds may offer reasonable returns in the short-term but not for the long-term. A reliable way to ensure a fund's steadiness is to see its performance for the past five years or more. Also consider other factors such as the expense ratio, the fund manager's track record and the track record of the AMC. This can help you make a better investment decision.

4) Tax-saving is not the only purpose of investment

You can avail tax deductions of Rs. 1.5 lakh each year by investing in ELSS. However, you may want to know that mutual funds offer a lot more than tax subsidies. , investment discipline and the potential to earn a significant corpus for your future are some of its benefits. So, consider your mutual fund investments for the long-term rather than a last-minute recourse before the tax deadlines.

5) SIP instead of lump-sum investments

You can invest in mutual funds through Systematic Investment Plans (SIPs) or a lump sum. But as a new investor, SIP could be the better option. You can use a [SIP calculator](#) to calculate and estimate the returns on your SIP investment.

Investing through a lump sum requires timing the market and investing at the right moment. If you invest when the market is at a high, you could risk losing money. Generally, lump-sum investments are suited for experienced investors.

But in the case of SIPs, you can invest a fixed amount of money (monthly, quarterly, semi-annually etc.) regardless of how the market performs. This method ensures you get the opportunity to invest at different market levels. As a result, you may earn higher returns over time.

6) Returns are not guaranteed

Mutual funds have the potential to offer reasonable yields. But that does not mean you are guaranteed returns. Since the returns are linked to the market's performance, you could lose money on your investments when the market performs poorly. This is why it is critical to choose your funds carefully.

7) Consult an advisor

There are many different mutual funds in the market. Choosing the right fund among all the varied options can confuse new investors. In case you are unsure about how and where to invest, consult a financial advisor. A financial advisor can help you decide based on your goals and finances.

How to invest in mutual funds

Investing in mutual funds is uncomplicated and straightforward.

Follow these steps to get started on your mutual fund investment journey:

Step #1: Sign up for a mutual fund account on www.franklintempletonindia.com

Step #2: Complete your KYC formalities (ignore this step if you have already done it)

Step #3: Enter the necessary details

Step #4: Identify the funds you wish to invest based on your financial goals

Step #5: Select the appropriate fund and transfer the amount

Step #6: Issue a standing instruction with your bank in case you invest through a SIP every month.

Conclusion

A well-known financial proverb says that to become wealthy, you should be able to make money even while you sleep. Investing in mutual funds can be an effortless way of achieving this goal. When you invest in mutual funds every month, your corpus grows. It could have a slow start, but with time, your investment may grow to a large extent. Identify your goals, select the appropriate funds and start investing.

NEXT TO COME: A DEFINITIVE GUIDE TO SYSTEMATIC METHODS: SIP, SWP & STP