CHAPTER 1: CONCEPT AND ROLE OF A MUTUAL FUND (6 marks)

Concept of Mutual Fund

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. Anybody with an investible surplus of as little as a few hundred rupees can invest in Mutual Funds. These investors buy units of a particular Mutual Fund scheme that has a defined investment objective and strategy.

The money thus collected is then invested by the fund manager in different types of securities. These could range from shares to debentures to money market instruments, depending upon the scheme’s stated objectives. The income earned through these investments and the capital appreciation realized by the scheme is shared by its unit in proportion to the number of units owned by them.

Thus a Mutual Fund offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low-cost.

TYPES OF MUTUAL FUND SCHEMES

By Structure

Open-Ended Schemes do not have a fixed maturity. You deal with the Mutual Fund for your investments & Redemptions. The key feature is liquidity. You can conveniently buy and sell your units at Net Asset Value (NAV) related prices, at any point of time. Investors can sell their units to the scheme through a re-purchase transaction at re-purchase price, which is linked to NAV.

Close-Ended Schemes have a stipulated maturity period are called close ended schemes. You can invest in the scheme at the time of the initial issue and thereafter you can buy or sell the units of the scheme on the stock exchanges where they are listed.

Interval Schemes combine the features of open-ended and close-ended schemes. The periods when an interval scheme becomes open-ended, are called „transaction periods“; the period between the close of a transaction period, and the opening of the next transaction period is called „interval period“. Minimum duration of transaction period is 2 days, and minimum duration of interval period is 15 days. No redemption/repurchase of units is allowed except during the specified transaction period (during which both subscription and redemption may be made to and from the scheme). Scheme should be compulsorily listed in Stock Exchange during the interval period.

Actively Managed Funds and Passive Funds

Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. Since this increases the role of the fund manager, the expenses for running the fund turn out to be higher. Investors expect actively managed funds to perform better than the market.

Passive funds invest on the basis of a specified index, whose performance it seeks to track. Thus, a passive fund tracking the S&P BSE Sensex would buy only the shares that are part of the composition of the S&P BSE Sensex. The proportion of each share in the scheme’s portfolio would also be the same as the weightage assigned to the share in the computation of the S&P BSE Sensex. Thus, the performance of these funds tends to mirror the concerned index. They are not designed to perform better than the market. Such schemes are also called index schemes. Since the portfolio is determined by the index itself, the fund manager has no role in deciding on investments. Therefore, these schemes have low running costs.
Exchange Traded Funds (ETFs) are also passive funds whose portfolio replicates an index or benchmark such as an equity market index or a commodity index. The units are issued to the investors in a new fund offer (NFO) after which they are available for sale and purchase on a stock exchange. Units are credited to the investor’s demat account and the transactions post-NFO is done through the trading and settlement platforms of the stock exchange. The units of the ETF are traded at real time prices that are linked to the changes in the underlying index.

**SEBI - Categorization and Rationalization of Mutual Fund Schemes**

The Schemes would be broadly classified in the following groups as per SEBI guidelines: Equity Schemes, Debt Schemes, Hybrid Schemes, Solution Oriented Schemes, Other Schemes

**Equity Schemes SEBI has defined large cap, mid cap and small cap companies as follows:**

a. Large Cap: 1st -100th company in terms of full market capitalization  
b. Mid Cap: 101st -250th company in terms of full market capitalization  
c. Small Cap: 251st company onwards in terms of full market capitalization  
Also an Equity scheme should invest minimum 65% of its assets in Equity and Equity related instruments.

**Multi Cap Fund:** Investing across large cap, mid cap, small cap stocks. The minimum investment in equity and equity related instruments shall be 65 percent of total assets.

**Large Cap Fund:** Investing in large cap stocks. The minimum investment in equity and equity related instruments of large cap companies shall be 80 percent of total assets.

**Mid Cap Fund:** Investing in mid cap stocks. The minimum investment in equity and equity related instruments of mid cap companies shall be 65 percent of total assets.

**Large and Mid-Cap Fund:** Investing in both large cap and mid cap stocks. Large cap Stocks – Minimum 35%, Mid Cap stocks – Min 35% of total assets.

**Dividend Yield Fund:** Predominantly investing in dividend yielding stocks.

**Value Fund & Contra Fund:** A value fund follows a value investment strategy. Minimum investment in equity & equity related instruments shall be 65 percent of total assets. Value Schemes invest in Undervalued Companies. Investments in value funds yield benefits over longer holding periods. A contra fund follows contrarian investment strategy. Mutual Funds will be permitted to offer either Value fund or Contra fund.

**Focused Fund:** Investing in maximum 30 stocks (the scheme needs to mention where it intends to focus, viz., multi cap, large cap, mid cap, small cap).

**Sectoral/ Thematic:** Investing in a specific sector such as Pharma, FMCG is a sectoral fund. The minimum investment in equity & equity related instruments of a particular sector/ particular theme shall be 80 percent of total assets. Sectoral fund schemes are ideal for investors who have decided to invest in a particular sector. Thematic funds invest in line with an investment theme. The investment is more broad-based than a sector fund; but narrower than a diversified equity fund.

**Equity Linked Savings Schemes (ELSS)** are diversified equity funds that offer tax benefits to investors under section 80 C of the Income Tax Act up to an investment limit of Rs. 150,000 a year. ELSS are required to hold at least 80 percent of its portfolio in equity instruments. The investment is subject to lock-in for a period of 3 years during which it cannot be redeemed, transferred or pledged. However, this is subject to change in case there are any amendments in the ELSS Guidelines with respect to the lock-in period.

**Equity Index Fund schemes** are ideal for investors who are satisfied with a return approximately equal to that of an index. These schemes attempt to replicate the performance of a particular index such as the BSE Sensex, the NSE 50 (NIFTY).
Invests in Index Stocks as per the Weightage. Fund Manager has no role in deciding on investments. These funds are not designed to outperform the Index and have Low Running Cost. An Index Fund with Low Tracking Error is a Good Fund. Index fund is an example of Passive style of Fund management.

**DEBT Funds**

**Overnight Fund**: The investment is in overnight securities having maturity of 1 day.

**Liquid Fund**: Investment is into debt & money market securities with maturity of up to 91 days

**Ultra Short Duration Fund**: Investing in debt and money market instruments with Macaulay duration between 3 months and 6 months.

**Low Duration Fund**: Investing in debt and money market instruments with Macaulay duration between 6 months and 12 months.

**Money Market Fund**: Investing in money market instruments having maturity up to 1 year.

**Short Duration Fund**: Investing in debt and money market instruments with Macaulay duration between 1 year and 3 years.

**Medium Duration Fund**: Investing in debt and money market instruments with Macaulay duration of the portfolio being between 3 years and 4 years. Portfolio Macaulay duration under anticipated adverse situation is 1 year to 4 years.

**Medium to Long Duration Fund**: Investing in debt and money market instruments with Macaulay duration between 4 years and 7 years. Portfolio Macaulay duration under anticipated adverse situation is 1 year to 7 years.

**Long Duration Fund**: Investing in debt and money market instruments with Macaulay duration greater than 7 years.

**Dynamic Bond**: An open ended dynamic debt scheme investing across duration.

**Corporate Bond Fund**: An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds. The minimum investment in corporate bonds shall be 80 percent of total assets (only in AA+ and above rated corporate bonds)

**Credit Risk Fund**: Investing in below highest rated corporate bonds. The minimum investment in corporate bonds shall be 65 percent of total assets only in AA and below rated corporate bonds (excludes AA+ rated corporate bonds). Banking and PSU Fund: Investing in debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds. The minimum investment in such instruments should be 80 percent of total assets.

**Gilt Fund**: Investing in government securities across maturity. The minimum investment in Gsecs is defined to be 80 percent of total assets (across maturity).

** Floater Fund**: An open ended debt scheme predominantly investing in floating rate instruments. Minimum investment in floating rate instruments shall be 65 percent of total assets. For example, a debt security where interest payable is described as ‘5-year Government Security yield plus 1 percent’, will pay interest rate of 7 percent, when the 5-year Government Security yield is 6 percent; if 5-year Government Security yield goes down to 3 percent, then only 4 percent interest will be payable on that debt security. The NAVs of such schemes fluctuate lesser than other debt funds that invest more in debt securities offering a fixed rate of interest.

**Fixed Maturity Plans** are a kind of debt fund where the duration of the investment portfolio is closely aligned to the maturity of the scheme. AMCs tend to structure the scheme around pre-identified investments. Further, being close-
ended schemes, they do not accept money post-NFO, therefore, the fund manager has little ongoing role in deciding on the investment options. Such a portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity (though there can be no guarantee or assurance of such returns). This helps them compare the returns with alternative investments like bank deposits.

**Hybrid Funds** – Investing in two or more asset class

Conservative Hybrid Fund: Investment in debt instruments 75% and 90% of total assets while investment in Equity shall be between 10% and 25% of total assets.

**Balanced Hybrid Fund**: Investment in equity 40% to 60%, investment in debt 40% to 60%. Arbitraging is not permitted in this scheme.

**Aggressive Hybrid Fund**: Investment in equity 65% to 80% of total assets while investment in debt instruments shall be between 20% and 35% of total assets. Mutual funds in India are permitted to offer either Aggressive Hybrid Fund or Balanced Fund. Dynamic Asset Allocation or Balanced Advantage: It is an open ended dynamic asset allocation fund with investment in equity/debt that is managed dynamically.

**Multi Asset Allocation**: An open ended scheme investing in at least three asset classes with a minimum allocation of at least 10 percent each in all three asset classes. Foreign securities are not treated as a separate asset class in this kind of scheme.

**Arbitrage Fund**: Investing in arbitrage opportunities. The minimum investment in equity and equity related instruments shall be 65 percent of total assets. They simultaneously buy and sell securities in different markets to take advantage of the price difference. Returns are more in line with money market returns, rather than equity market returns. Moderately Low Risk Category. Arbitrage funds are not meant for equity risk exposure, but to lock into a better risk-return relationship than liquid funds and ride on the tax benefits that equity schemes offer.

**Solution Oriented Schemes**

**Retirement Fund**: An open ended retirement solution oriented scheme having a lock-in of 5 years or till retirement age (whichever is earlier).

**Children's Fund**: An open ended fund for investment for children having a lock-in for at least 5 years or till the child attains age of majority (whichever is earlier).

**Other Schemes**

**Gold Exchange Traded Funds (GETFs)** – Gold Exchange Traded Funds offer investors an innovative, cost-efficient and secure way to access the gold market. Gold ETFs are intended to offer investors a means of participating in the gold bullion market by buying and selling units on the Stock Exchanges, without taking physical delivery of gold. GOLD ETF invests in 99.99% pure GOLD. NAV of GOLD ETF depends on Real Prices of GOLD Bullion. Gold funds invest in gold and gold-related securities. Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. Passive funds invest on the basis of a specified index, whose performance it seeks to track. Capital Protected Schemes are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market.

**Real estate funds invest in real estate**. Commodity funds invest in asset classes like food crops, spices, fibres, industrial metals, energy products or precious metals as may be permitted by their investment charter. Direct investing in Commodities is not allowed in India.

**Fund of Funds (FOFs)** - Fund of Funds are schemes that invest in other mutual fund schemes. Minimum investment in the underlying fund - 95% of total assets.
Funds Investing Abroad – Off Shore Schemes - Mutual Funds have been permitted to invest in foreign securities/American Depository Receipts (ADRs) / Global Depository Receipts (GDRs). Some of such schemes are dedicated funds for investment abroad while others invest partly in foreign securities and partly in domestic securities. While most such schemes invest in securities across the world there are also schemes which are country specific in their investment approach. Example: Franklin Asian Equity Fund, HSBC Brazil Fund.

Capital Protected Schemes are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market. This is ideally done by investing in Zero Coupon Government Securities whose maturity is aligned to the scheme’s maturity. (Zero coupon securities are securities that do not pay a regular interest, but accumulate the interest, and pay it along with the principal when the security matures).

As detailed in the following example, the investment is structured, such that the principal amount invested in the zero-coupon security, together with the interest that accumulates during the period of the scheme would grow to the amount that the investor invested at the start.

Suppose an investor invested Rs. 10,000 in a capital protected scheme of 5 years. If 5-year government securities yield 7 percent at that time, then an amount of Rs. 7,129.86 invested in 5-year zero-coupon government securities would mature to Rs. 10,000 in 5 years. Thus, by investing Rs. 7,129.86 in the 5-year zero-coupon government security, the scheme ensures that it will have Rs 10,000 to repay to the investor in 5 years.

After investing in the government security, Rs 2,870.14 is left over (Rs. 10,000 invested by the investor, less Rs. 7129.86 invested in government securities). This amount is invested in riskier securities like equities. Even if the risky investment becomes completely worthless (a rare possibility), the investor is assured of getting back the principal invested, out of the maturity money received on the government security.

Net Asset Value (NAV) – Current market price of the unit.
Sale Price - Is the price you pay when you invest in a scheme. Also called as Offer Price.
Sale Price = NAV + Entry Load
If the NAV of a scheme was Rs 11.00 per unit, and it were to charge entry load of 1 percent, the Sale Price would be Rs 11 + 1 percent on Rs 11 i.e. Rs 11.11. Since entry load is no longer permitted, the Sale Price is same as the NAV.

Repurchase Price - Price at which units are repurchased / Redeemed by the Mutual Fund.
NAV = Repurchase Price – Exit Load
If the NAV of a scheme is Rs. 11.00 per unit, and it were to charge exit load of 1 percent, the Re-purchase Price would be Rs. 11 – 1 percent on Rs. 11 i.e. Rs. 10.89.

For better understanding, kindly watch below video: https://bit.ly/2LC7eHV

WHY SHOULD YOU INVEST IN MUTUAL FUNDS?

1. Professional Management - You avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team.

2. Diversification - Mutual Funds invest in a number of companies belonging to different industries and sectors. This diversification reduces the risk.

3. Convenient Administration - Mutual Funds save your time and make investing easy and convenient.

4. Return Potential - Over a medium to long term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.
5. Low Costs - Mutual Funds are a relatively less expensive to directly investing in the capital markets because the benefits of reduction in share brokerage which translate into lower costs for investors.

6. Liquidity - In open-ended schemes, you can get your money back promptly at Net Asset Value (NAV) related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price.

7. Transparency - You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager’s investment strategy and outlook.

8. Flexibility - Through features such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP) and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

9. Well Regulated - All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors.

Mutual funds mobilize different pools of money. Each such pool of money is called a mutual fund scheme. Mutual funds offer investors within a scheme various options, such as dividend payout option, dividend reinvestment option and growth option.

An investor buying into a scheme gets to select the preferred option also. The investment that an investor makes in a scheme is translated into a certain number of “Units” in the scheme. The number of units multiplied by its face value (Rs10) is the capital of the scheme – its Unit Capital.

When the profitability metric is positive, the true worth of a unit, also called Net Asset Value (NAV) goes up. When a scheme is first made available for investment, it is called a “New Fund Offer” (NFO). The money mobilized from investors is invested by the scheme as per the investment objective committed. Profits or losses, as the case might be, belong to the investors. The investor does not however bear a loss higher than the amount invested by him.

The relative size of mutual fund companies is assessed by their assets under management (AUM). The AUM captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.

Lack of portfolio customization and an overload of schemes & scheme variants are drawbacks.

CHAPTER 2: FUND STRUCTURE AND CONSTITUENTS (4 Marks)

SEBI has stipulated the legal structure under which mutual funds in India need to be constituted. The structure, which has inherent checks and balances to protect the interests of the investors, can be briefly described as follows:

- Mutual funds are constituted as Trusts. Therefore, they are governed by the Indian Trusts Act, 1882
- The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund business.
- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- The operations of the mutual fund trust are governed by a Trust Deed, which is executed between the sponsors and the trustees.
- The Trust acts through its trustees. Therefore, the role of protecting the interests of the beneficiaries (investors) is that of the Trustees. The first trustees are named in the Trust Deed, which also prescribes the procedure for change in Trustees.
• In order to perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed as trustees, they are jointly referred to as ‘Board of Trustees’. A trustee company functions through its Board of Directors.

• Day to day management of the schemes is handled by an Asset Management Company (AMC). The AMC is appointed by the sponsor or the Trustees.

• The trustees execute an investment management agreement with the AMC, setting out its responsibilities.

• Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.

• Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).

Let us understand the various agencies, by taking the example of the constitution of SBI Mutual Fund

<table>
<thead>
<tr>
<th>Mutual Fund Trust</th>
<th>SBI Mutual Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sponsor</td>
<td>State Bank of India</td>
</tr>
<tr>
<td>Trustee</td>
<td>SBI Mutual Fund Trustee Company Private Limited</td>
</tr>
<tr>
<td>AMC</td>
<td>SBI Funds Management Private Limited</td>
</tr>
<tr>
<td>Custodian</td>
<td>HDFC Bank Limited</td>
</tr>
<tr>
<td></td>
<td>SBI-SG Global Securities Services Private Limited</td>
</tr>
<tr>
<td></td>
<td>Bank of Nova Scotia (custodian for Gold)</td>
</tr>
<tr>
<td>RTA</td>
<td>Computer Age Management Services (CAMS) Pvt. Ltd</td>
</tr>
</tbody>
</table>

**Key Constituents of a Mutual Fund**

**Sponsors**
The sponsor invests in the capital of the AMC. Since sponsors are the main people behind the mutual fund operation, eligibility criteria have been specified as follows:
The sponsor should have a sound track record and reputation of fairness and integrity in all business transactions. The requirements are:

• Sponsor should be carrying on business in financial services for not less than 5 years.
• Sponsor should have positive net worth (share capital plus reserves minus accumulated losses) in all the immediately preceding 5 years.
• The sponsor should have earned profits, after providing for depreciation and interest and tax, in three of the previous five years, including the latest year.
The sponsor should be a fit and proper person for this kind of operation. The sponsor needs to contribute a minimum 40 percent of the net worth of the AMC.

**Trustee**
The trustees have a critical role in ensuring that the mutual fund complies with all the regulations, and protects the interests of the unit-holders.

**Asset Management Company (AMC)**
Day to day operations of mutual fund is handled by the AMC. The sponsor or, the trustees if so authorized by the trust deed, shall appoint the AMC with the approval of SEBI.

*Compliance Officer* needs to ensure all the legal compliances. In the offer documents of new issues, the Compliance Officer signs a due-diligence certificate to the effect that all regulations have been complied with, and that all the intermediaries mentioned in the offer document have the requisite statutory registrations and approvals. In order to ensure independence, the Compliance Officer reports directly to the head of the AMC. Further, he works closely with the Trustees on various compliance and regulatory issues.
Custodian
The custodian has custody of the assets of the fund. As part of this role, the custodian needs to accept and give delivery of securities for the purchase and sale transactions of the various schemes of the fund. Thus, the custodian settles all the transactions on behalf of the mutual fund schemes.
All custodians need to register with SEBI under the SEBI (Custodian of Securities) Regulations 1996. The Custodian is appointed by the trustees. A custodial agreement is entered into between the trustees and the custodian.

Registrars and Transfer Agents (RTA)
The Registrars and Transfer Agents (RTA) maintain investor records. The appointment of RTA is done by the AMC. It is not compulsory to appoint a RTA. The AMC can choose to handle this activity in-house. All RTAs need to register with SEBI.

Auditors
Auditors are responsible for the audit of accounts. Accounts of the mutual fund schemes need to be maintained independent of the accounts of the AMC.

Fund Accountants
The fund accountant performs the role of calculating the NAV, by collecting information about the assets and liabilities of each scheme. The AMC can either handle this activity in-house, or engage a service provider. There is no need for a registration with SEBI to perform this function.

Distributors
Distributors have a key role in selling suitable types of units to their clients i.e. the investors in the schemes of mutual funds with whom they are empanelled. A distributor can be empanelled with more than one mutual fund. Distributors can be individuals or institutions such as distribution companies, broking companies and banks.

KYC Registration Agencies (KRA)
To do away with multiple KYC formalities with various intermediaries, SEBI has mandated a unified KYC for the securities market through KYC Registration Agencies (KRA) registered with SEBI. Any new investor, Joint holders, Power of Attorney holders, Donors and Guardian (in case of minors) have to comply with the KYC formalities. In-Person Verification (IPV) by a SEBI-registered intermediary is compulsory for all investors. However, the investor needs to get IPV done by only one SEBI-registered intermediary (broker, depository, mutual fund distributor etc.).

Central KYC (cKYC)
cKYC refers to Central KYC (Know Your Customer), an initiative of the Government of India. The aim of this initiative is to have a structure in place which allows investors to complete their KYC only once before interacting with various entities across the financial sector. cKYC is managed by CERSAI (Central Registry of Securitization Asset Reconstruction and Security Interest of India), which is authorized by the Government of India to function as the Central KYC Registry (cKYCR). The objective of cKYCR is to reduce the burden of producing KYC documents and getting those verified every time when the investor deals with a financial entity for the first time.

CHAPTER 3: LEGAL AND REGULATORY ENVIRONMENT (10 Marks)
Securities and Exchange Board of India (SEBI) is the regulatory authority for securities markets in India. It regulates, among other entities, mutual funds, depositories, custodians and registrars and transfer agents in the country. Anyone who is aggrieved by a ruling of SEBI, can file an appeal with the Securities Appellate Tribunal (SAT).

Self-Regulatory Organizations (SRO)
In the developed world, it is common for market players to create Self-Regulatory Organizations, whose prime responsibility is to regulate their own members.
NSE, BSE and MSEI are vested with self-regulatory responsibilities. They regulate the firms listed on their stock exchange and also their trading members.
Association of Mutual Funds in India

Asset Management Companies (AMCs) in India are members of Association of Mutual Funds in India (AMFI), an industry body that has been created to promote the interests of the mutual funds industry. AMFI is not an SRO.

The objectives of AMFI are as follows:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others
- To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.
- To undertake nationwide investor awareness program so as to promote proper understanding of the concept and working of mutual funds.

The AMFI Code of Ethics sets out the standards of good practices to be followed by the Asset Management Companies in their operations and in their dealings with investors, intermediaries & the public.

AMFI has framed AGNI, a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products.

Investment objective defines the broad investment charter. Investment policy describes in greater detail, the kind of portfolio that will be maintained. Investment strategies are decided on a Day-to-day basis by the senior management of the AMC.

**Investors’ Rights & Obligations**

1. Under the SEBI guidelines, NFOs other than ELSS can remain open for a maximum of 15 days. Allotment of units or refund of moneys should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale / re-purchase within 5 business days of the allotment. In case of ELSS, the allotment must be done within 30 days.

2. Receive dividend within 30 days of their declaration and receive the redemption or repurchase proceeds within 10 working days from the date of redemption or repurchase. Failing which AMC has to pay a penalty of 15% per annum basis.

3. Receive communication from the Trustees about change in the fundamental attributes of any scheme or any other changes which would modify the scheme and affect the interest of the unit holders & to have option to exit at prevailing Net Asset Value without any exit load. 4. To disclose your schemes’ entire portfolio twice a year, un audited financial results half yearly and audited annual accounts once a year.

5. Investors can choose to change their distributor or go direct. In such cases, AMCs will need to comply, without insisting on any kind of No Objection Certificate from the existing distributor.

6. Unit-holders have the right to inspect key documents such as the Trust Deed, Investment Management Agreement, Custodial Services Agreement, R&T agent agreement and Memorandum & Articles of Association of the AMC.

7. Scheme-wise Annual Report or an abridged summary has to be mailed to all unit-holders within 6 months of the close of the financial year.

8. PAN based Consolidated Account Statement (CAS) for each calendar month will be sent by post/email on or before 10th of the succeeding month.

9. SOA to dormant investors (no transaction during the previous 6 months) can be sent along with the Portfolio Statement / Annual Return. 10. In the case of SIP / STP / SWP SoA dispatched within 10 working days of Initial transaction and thereafter Once in a Quarter.

11. On specific request, SOA to be sent within 5 working days. Statement of accounts (SOA) is to be sent to investors within 5 days of closure of the NFO.

12. Investor can ask for a Unit Certificate for his Unit Holding. It is different from a SOA. SOA contains opening balance, transactions during the period & closing balance. A Unit Certificate mentions the number of Units held by the investor.
SOA is like a Bank pass book. Unit Certificate is like a Balance Confirmation Certificate. Unit Certificates are non-transferable & no transactional convenience. Unit Certificate if requested then AMC will issue within 5 days.

13. The investor/s can appoint upto 3 nominees, who will be entitled to the Units in the event of the demise of the investor/s. The investor can also pledge the units. This is normally done to offer security to a financier.

14. Units of all mutual fund schemes held in demat form are freely transferable. Investors have the option to receive allotment of mutual fund units of open ended and closed end schemes in their demat account.

15. NAV has to be published daily, in at least 2 daily newspapers having circulation all over India. NAV and re-purchase price are to be updated in the website of AMFI and the mutual fund. NAV is to be calculated up to 4 decimal places in the case of index funds, liquid funds and other debt funds. NAV for equity and balanced funds is to be calculated up to at least 2 decimal places. Investors can hold their units even in a fraction of 1 unit.

16. For Fund of Funds NAV updated in AMFI Site by 10 am the following day. For other schemes NAV updated in AMFI Site by 9 pm the same day.

17. The mutual fund has to publish a complete statement of the scheme portfolio and the unaudited financial results, within 1 month from the close of each half year. In lieu of the advertisement, the mutual fund may choose to send the portfolio statement to all Unit Holders.

18. Debt-oriented, close-ended/interval, schemes/plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.

19. The Annual Report of the AMC has to be displayed on the website of the mutual fund. The Scheme-wise Annual Report will mention that Unit-holders can ask for a copy of the AMC’s Annual Report.

20. The trustees/AMC cannot make any change in the fundamental attributes of a scheme, unless the requisite processes have been complied. This includes option to dissenting unit-holders to exit at the prevailing Net Asset Value, without any exit load. This exit window has to be open for at least 30 days.

21. The appointment of the AMC for a mutual fund can be terminated by a majority of the trustees or by 75% of the Unit-holders of the Scheme. 75% of the Unit-holders can pass a resolution to wind-up a scheme.

**Limitation of Rights of Unit-holders**

If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust. Under the law, a trust is a notional entity. Therefore, investors cannot sue the trust (but they can file suits against trustees, as seen above). The principle of caveat emptor (let the buyer beware) applies to mutual fund investments. Protections under the Companies Act, 2013 are not available to investors in a mutual fund scheme.

**Unclaimed Amounts:**

The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market. AMC can recover investment management and advisory fees on management of these unclaimed amounts, at a maximum rate of 0.50% p.a. The investor can claim his moneys from the scheme within 3 years. Payment will be based on prevailing NAV. If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years.

If a security that was written off earlier is now recovered, within 2 years of closure of the scheme, and if the amounts are substantial, then the amount is to be paid to the old investors. In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund.

Investors need to give their bank account details along with the redemption request. Adequate safeguards exist to protect the investors from the possibility of a scheme going bust.
CHAPTER 4: OFFER DOCUMENT (6 Marks)

NFO
Units in a mutual fund scheme are offered to public investors for the first time through a NFO. The offer is made through a legal document called the Offer Document.
Three dates are relevant for the NFO of an open-ended scheme:

- NFO Open Date – This is the date from which investors can invest in the NFO
- NFO Close Date – This is the date up to which investors can invest in the NFO
- Scheme Re-Opening Date – This is the date from which the investors can offer their units for re-purchase to the scheme (at the re-purchase price); or buy new units of the scheme (at the sale price, which is the NAV itself). The AMC announces Sale and Re-purchase prices from the Scheme Re-Opening Date.

Close-ended Schemes have an NFO Open Date and NFO Close Date. But, they have no Scheme Re-opening Date, because the scheme does not sell or re-purchase units. Investors will need to buy or sell units in the stock exchange(s) where the scheme is listed.

Under the SEBI guidelines, NFOs other than ELSS can remain open for a maximum of 15 days. Allotment of units or refund of moneys, as the case may be, should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale and re-purchase within 5 business days of the allotment.

The Offer Document is the most important source of information on the core aspects of the scheme called its fundamental attributes. The fundamental attributes of the scheme include:

The type of scheme
- Open-ended/ Close-ended/ Interval
- Equity fund/Debt fund/Hybrid/Any other type of fund

Investment objective(s) and Investment Pattern of the scheme
- Investment objective- Growth/Income/Both
  - Investment pattern-The indicative break-up of the portfolio between equity, debt and money market instruments with minimum and maximum allocation to each. The fund could retain the right to alter the allocation for defensive consideration.

Terms of the issue
- Liquidity provisions such as listing, repurchase and redemption
- Fees and expenses charged to the scheme
- Any safety net or guarantee provided

Mutual Fund Offer Documents have two parts:
(a) Scheme Information Document (SID), which has details of the scheme. The SID contains the following information of the scheme

Name and type
The NFO dates (opening, closing, re-opening)
Name and details of the mutual fund, sponsor, AMC, Trustees and constituents
Investment objective, investment pattern, strategy and style
Risk factors
  - Standard
  - Scheme specific
Benchmark
(b) Statement of Additional Information (SAI), which has statutory information about the mutual fund that is offering the scheme. The content of the same is as follows:

- Information about Sponsors, AMC and Trustee company
  - Contact information
  - Shareholding pattern
  - Roles & Responsibilities
  - Names of directors and their contact information
  - Profiles of key personnel
- Contact information of service providers
- Rights of unit-holders
- Investment valuation norms
- Condensed financial information of schemes

In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID. Both documents need to be updated regularly.

Offer Documents in the market are “vetted” by SEBI, though SEBI does not formally “approve” them. KIM is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

Scheme Information Document (SID) – has details of the scheme. Draft SID is available for viewing in SEBI website for 21 working days. Final SID is hosted on AMFI site 2 days before the issue opens.

Statement of Additional Information (SAI) contains statutory information. Single SAI is enough for all the schemes of a Mutual Fund. SAI is part of SID. SID should be read in conjunction with the SAI and not in Isolation.

Key Information Memorandum (KIM) is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

Contents of KIM: Name of the AMC, mutual fund, Trustee, Fund Manager and scheme - Dates of Issue Opening, Issue Closing & Re-opening for Sale and Re-purchase - Plans and Options under the scheme - Risk Profile of Scheme - Price at which Units are being issued - Benchmark - Dividend Policy

Imp points:

- SID, SAI & KIM is to be updated at least once a year.
- Caveat Emptor: An investor is presumed to have read the offer document. At a future date, an investor cannot claim of being unaware of a fact disclosed in the offer document

RISK CLASSIFICATION BASED ON RISKOMETER

Riskometer: To enable investors to take informed decision regarding their investments, a pictorial representation of the risk to the principal invested in a mutual fund product is depicted using a ‘Riskometer’. The pictometer will categorize the risk in the scheme at one of five levels of risk, as shown in the table below. There will also be a written statement of the risk to the principal below the ‘Riskometer’.
### Level of Risk

<table>
<thead>
<tr>
<th>Level of Risk</th>
<th>Definition</th>
<th>Example of the Type of Mutual Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low (blue)</td>
<td>Principal at low risk</td>
<td>Overnight Fund/Liquid Fund</td>
</tr>
<tr>
<td>Moderately Low (blue)</td>
<td>Principal at moderately low risk</td>
<td>Fixed Maturity Plans/Capital Protection Oriented Scheme</td>
</tr>
<tr>
<td>Moderate (yellow)</td>
<td>Principal at moderate risk</td>
<td>Income Fund/Conservative Monthly Income Plans</td>
</tr>
<tr>
<td>Moderately High (brown)</td>
<td>Principal at moderately high risk</td>
<td>Index Fund/Exchange Traded Fund/Equity Dividend Yield Fund/ Solution oriented schemes</td>
</tr>
<tr>
<td>High (brown)</td>
<td>Principal of high risk</td>
<td>Sector Fund/Thematic Fund</td>
</tr>
</tbody>
</table>

### CHAPTER 5: FUND DISTRIBUTION AND CHANNEL MANAGEMENT PRACTICES (8 marks)

#### Institutional Channels

The changing competitive context led to the emergence of institutional channels of distribution for a wide spectrum of financial products. This comprised:

- Brokerage firms and other securities distribution companies, who widened their offering beyond company fixed deposits and public issue of shares.
- Banks, who started viewing distribution of financial products as a key avenue to earn fee-based income, while addressing the investment needs of their customers.
- Non-banking finance companies (NBFC) with multiple branches

The institutional channels started attracting agents as sub-brokers.

#### Newer Distribution Channels

**The internet** gave an opportunity to mutual funds to establish direct contact with investors. Investors can now access the website of the mutual fund and deal directly with the fund. Direct transactions afford scope to optimize on the commission costs involved in distribution.

A large mass of investors in the market need advice. The future of intermediaries lies in catering to their needs, personally and/or through a team and/or with support of technology.

#### Stock Exchanges

SEBI has facilitated buying and selling of mutual fund units through the stock exchanges. Both NSE and BSE have developed mutual fund transaction engines for the purpose. The low cost and deeper reach of the stock exchange network has increased the participation level of retail investors in mutual funds, and thereby taking the mutual fund industry into its next wave of growth. Following important points one should remember:

- Close-ended schemes are required to be listed in a stock exchange
- ETFs are bought and sold in the stock exchange.

#### Distribution through Banks

- Mutual funds have built relationships with PSU banks that have a wide reach in the non-urban centres to distribute mutual fund products through them. Also private and foreign banks actively participate in the distribution process of mutual fund products.
Pre-requisites to become Distributor of a Mutual Fund

SEBI has mandated mutual fund distributors, agents or any persons employed or to be employed in the sale and/or distribution of mutual fund products, to have a valid certification from the National Institute of Securities Markets (NISM) by passing NISM Series-V-A: Mutual Fund Distributors Certification Examination.

In order to be eligible to sell or market mutual funds, the following are compulsory:

**Obtaining NISM Certification**

- The individual needs to pass the NISM certification examination mandated by SEBI.
- For persons who have attained the age of 50 years or who have at least 10 years of experience in the securities markets in the sale and/ or distribution of mutual fund products as on May 31, 2010, can obtain the certification either by passing the NISM certification examination or qualifying for Continuing Professional Education (CPE) by obtaining such classroom credits as may be specified by NISM from time to time.

**Know Your Distributor (KYD) Requirements**

As part of SEBI’s drive to streamline the distribution process of mutual fund products, AMFI has introduced the KYD process to verify the correctness of the information provided in the registration documents and to have verification of the ARN holders.

- The process consists of document verification and bio-metric process.
- Self-attested copy of the PAN card and specific documents as proof of address to be submitted along with application form at the CAMS-PoS (Computer Age Management Services-Points of Service). The original documents have to be presented for verification.
- Bio-metric process consists of taking the impression of the index finger of the right hand of the ARN holder. This is done at the PoS at the time of submission of documents (both for new registrations and renewal of ARN). In case of non-individual distributors, bio-metric process will be conducted on specified authorized persons.

**Obtaining AMFI Registration Number (ARN)**

- After obtaining the certification and completing KYD requirements, the next stage is to register with AMFI. On registration, AMFI allots an AMFI Registration Number (ARN). Individuals from the exempted category (i.e. who have attained the age of 50 years or have at least 10 years of experience as of May 31, 2010) can obtain the ARN without passing the certifying examination, provided they have attended the prescribed CPE program.

**Empanelment with AMCs**

- Armed with the ARN No., the IFA / distributor / stock exchange broker can get empanelled with any number of AMCs. Alternatively, they can become agents of a distributor who is already empanelled with AMCs.
- Empanelment with the AMC or enrolment as an agent of an empanelled distributor is compulsory to be able to sell mutual fund schemes and earn the commissions.

*The employees need to obtain an Employee Unique Identification Number (EUIN) from AMFI apart from AMFI Registration Number (ARN). The Intermediaries have to ensure that the employees quote the EUIN in the Application Form for investments.*

**Commission Structures**

There are no SEBI regulations regarding the minimum or maximum commission that distributors can earn. However, SEBI has laid down limits on what the total expense (including commission) in a scheme can be. This is discussed later. Any excess expense will need to be borne by the AMC i.e. it cannot be charged to the scheme.

The commission structures vary between AMCs. Even for the same AMC, different commissions are applicable for different kinds of schemes. Two kinds of commission are earned by distributors on their mobilization:
Initial or Upfront Commission, on the amount mobilized by the distributor.

The scheme application forms carry a suitable disclosure to the effect that the upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor. Investors should make sure that the commission costs they incur are in line with the value they get.

Trail commission is calculated as a percentage of the net assets attributable to the Units sold by the distributor. The commission payable is calculated on the daily balances and paid out periodically to the distributor as per the agreement entered into with AMC.

The trail commission is normally paid by the AMC on a quarterly basis or monthly basis. Since it is calculated on net assets, distributors benefit from increase in net assets arising out of valuation gains in the market.

For example, suppose an investor has bought 1000 units at Rs. 10 each. The distributor who procured the investment may have been paid an initial commission calculated as a percentage on 1000 units X Rs. 10 i.e. Rs 10,000.

Later, suppose the NAV of the scheme goes up to Rs.15. Trail commission is payable on 1000 units X Rs 15 i.e. Rs 15,000 – not the Rs 10,000 mobilised. In short, trail commission is depended on the NAV.

Transaction Charges is paid to distributors for investments of Rs. 10,000 and over. This does not apply to direct investments. For subscriptions from existing investors the distributor will be paid Rs. 100 per transaction and for new investors across mutual funds they will be paid Rs. 150 to encourage widening the investor base of mutual funds.

The transaction charge will be deducted from the gross investments of the investor and paid to the investor and the balance shall be invested. The statement of accounts (SoA) will show the net investment made as the gross subscription less transaction charge and give the number of units allotted against the net subscription.

Direct and Regular Plans

The direct plan is for investors who wish to invest directly in the mutual fund without routing the investment through a distributor. The Plan will have a lower expense ratio since there are no distribution expenses or commissions involved. The plan will have a separate NAV that will reflect the lower expenses under this plan.

Under the Regular plan the investor indicates a distributor through whose services the investment decision was made and executed. The expenses under the Regular plan are higher because of the distribution commissions involved.

If the ARN code is not mentioned and choice of plan is not indicated, then the application form will be processed as a Direct Plan application.

Commission Disclosure

SEBI has mandated Mutual Funds / AMCs to disclose on their respective websites the total commission and expenses paid to distributors who satisfy one or more of the following conditions with respect to non-institutional (retail and HNI) investors:

i. Multiple point of presence (More than 20 locations)
ii. AUM raised over Rs. 100 crore across industry in the non-institutional category but including high networth individuals (HNIs).
iii. Commission received of over Rs. 1 crore p.a. across industry
iv. Commission received of over Rs. 50 lakhs from a single Mutual Fund/AMC

SEBI Advertising Code

The important provisions pertaining to SEBI’s Advertising Code for mutual funds (MFs) are listed below:

- Advertisements shall be accurate, true, fair, clear, complete, unambiguous and concise.
- Advertisements shall not contain statements which are false, misleading, biased or deceptive, based on assumption/projections and shall not contain any testimonials or any ranking based on any criteria.
- No celebrities shall form part of the advertisement.
Advertisements shall be accompanied by a standard warning in legible fonts which states ‘Mutual Fund investments are subject to market risks, read all scheme related documents carefully.’ No addition or deletion of words shall be made to the standard warning.

In audio-visual media based advertisements, the standard warning in visual and accompanying voice over reiteration shall be audible in a clear and understandable manner. For example, in standard warning both the visual and the voice over reiteration containing 14 words running for at least 5 seconds may be considered as clear and understandable.

**Disclosing performance related information of mutual fund schemes**

When the mutual fund scheme has been in existence for more than 3 years:
1) Point-to-point returns on a standard investment of Rs. 10,000/- shall also be shown
2) Performance advertisement shall be provided in terms of CAGR for the last 1 year, 3 years, 5 years and since inception along with Benchmark Index.
3) In the case of money market schemes or Liquid schemes, the performance can be advertised by simple annualisation of yields for 7 days, 15 days and 30 days. Further, it should not give an unrealistic or misleading picture about the performance or future performance of the scheme.

**CHAPTER 6: ACCOUNTING, VALUATION AND TAXATION (10 marks)**

**Accounting and Expenses**

**Net Assets of Scheme**

- Let us understand the concept with a simple example.
- Investors have bought 20 crore units of a mutual fund scheme at Rs. 10 each. The scheme has thus mobilized 20 crore units X Rs. 10 per unit i.e. Rs 200 crore.
- An amount of Rs. 140 crore, invested in equities, has appreciated by 10 percent.
- The balance amount of Rs 60 crore, mobilized from investors, was placed in bank deposits. Interest and dividend received by the scheme is Rs 8 crore, scheme expenses paid is Rs 4 crore, while a further expense of Rs 1 crore is payable.

If the above details are to be captured in a listing of assets and liabilities of the scheme, it would read as follows:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amount (Rs. crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Unit Capital (20 crore units of Rs 10 each)</td>
<td>200</td>
</tr>
<tr>
<td>Profits {Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid) minus Rs 1 crore (expenses payable)}</td>
<td>3</td>
</tr>
<tr>
<td>Capital Appreciation on Investments held (10 percent of Rs 140 crore)</td>
<td>14</td>
</tr>
<tr>
<td><strong>Unit-holders’ Funds in the Scheme</strong></td>
<td>217</td>
</tr>
<tr>
<td>Expenses payable</td>
<td>1</td>
</tr>
<tr>
<td><strong>Scheme Liabilities</strong></td>
<td>218</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td></td>
</tr>
<tr>
<td>Market value of Investments (Rs 140 crore + 10 percent)</td>
<td>154</td>
</tr>
<tr>
<td>Bank Deposits (Rs 60 crore (original) plus Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid))</td>
<td>64</td>
</tr>
<tr>
<td><strong>Scheme Assets</strong></td>
<td>218</td>
</tr>
</tbody>
</table>

The unit-holders’ funds in the scheme is commonly referred to as “net assets”.

- A scheme cannot show better profits by delaying payments. While calculating profits, all the expenses that relate to a period need to be considered, irrespective of whether or not the expense has been paid. In accounting jargon, this is called accrual principle.
- Similarly, any income that relates to the period will boost profits, irrespective of whether or not it has been actually received in the bank account. This again is in line with the accrual principle.

**NISM Series V-A: Mutual Fund Distributors Certification Examination – Important Notes**
The summation of these three parameters gave us the profitability metric as being equal to:

(A) Interest income
(B) + Dividend income
(C) + Realized capital gains
(D) + Valuation gains
(E) – Realized capital losses
(F) – Valuation losses
(G) – Scheme expenses

Example 1: Calculate the NAV given the following information:
Value of stocks: Rs. 150 crore
Value of bonds: Rs. 67 crore
Value of money market instruments: Rs. 2.36 crore
Dividend accrued but not received: Rs. 1.09 crore
Interest accrued but not received: Rs. 2.68 crore
Fees payable: Rs. 0.36 crore
No. of outstanding units: 1.90 crore

NAV = \((\text{Value of stocks} + \text{Value of bonds} + \text{Value of money market instruments} + \text{Dividend accrued but not received} + \text{Interest accrued but not received} – \text{Fees payable}) / \text{No. of outstanding units}\)

NAV = \((150 + 67 + 2.36 + 1.09 + 2.68 – 0.36) / 1.90 = 222.77 / 1.90 = Rs. 117.25\)

Example 2: Calculate the NAV given the following information:
Value of stocks: Rs. 230 crore
Value of money market instruments: Rs. 5 crore
Dividend accrued but not received: Rs. 2.39 crore
Amount payable on purchase of shares: Rs. 7.5 crore
Amount receivable on sale of shares: Rs. 2.34 crore
Fees payable: Rs. 0.41 crore
No. of outstanding units: 2.65 crore

NAV = \((\text{Current value of investments held} + \text{Income accrued} + \text{Current assets} – \text{Current liabilities} – \text{Accrued expenses}) / \text{No. of outstanding units}\)

Income accrued is the dividend declared but not received. Expenses accrued include fees payable.

The NAV is calculated as:

NAV = \((230 + 5 + 2.39 + 2.34 – 7.5 – 0.41) / 2.65 = 231.82 / 2.65 = Rs. 87.48\)

NAV Calculation Video - https://www.youtube.com/watch?v=Lz0YUFimOTs&index=19&list=PLCZvkZJiAVK56z_al+5b4WMMRUXMWydc

Mark to Market

- The process of valuing each security in the investment portfolio of the scheme at its current market value is called ‘mark to market’ i.e. marking the securities to their market value. Why is this done?
- The NAV is meant to reflect the true worth of each unit of the scheme, because investors buy or sell units on the basis of the information contained in the NAV. If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought.

Loads

Schemes can also calibrate the load when investors offer their units for re-purchase. Investors would be incentivized to hold their units longer, by reducing the load as the unit holding period increased. For instance, load would be 4 percent if the investor were to exit in year 1, 3 percent if the investor were to exit in year 2, and so on. Such structures of load are called “Contingent Deferred Sales Charge (CDSC)”.
Transaction Charges

In order to cater to people with small saving potential and to increase reach of mutual fund products in urban areas and smaller towns, SEBI has allowed a transaction charge per subscription of Rs. 10,000/- and above to be paid to distributors of the Mutual Fund products. However, there shall be no transaction charges on direct investments. The transaction charge, if any, is deducted by the AMC from the subscription amount and paid to the distributor; and the balance amount is invested.

<table>
<thead>
<tr>
<th>Type of Investor</th>
<th>Transaction Charges (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First time mutual fund investor</td>
<td>Rs. 150/-</td>
</tr>
<tr>
<td>Investor other than first time mutual fund investor</td>
<td>Rs. 100/-</td>
</tr>
</tbody>
</table>

In the example of Rs. 25,000 investments at NAV of Rs. 43.21, suppose money came from a first-time mutual fund investor. Transaction charge would be deductible at Rs. 150. So the number of units allotted would be (Rs. 25,000 – Rs. 150) ÷ Rs. 43.21 i.e. 575.098.

In case of investments through SIP, Transaction Charges are deducted only if the total commitment (i.e. amount per SIP instalment x Number of instalments) amounts to Rs. 10,000 or more. The Transaction Charge is deducted in four equal instalments.

However, Transaction Charge(s) will not be deducted for the following:-

- When investor goes direct
- Distributors who have chosen the ‘opt-out’ option i.e. decided not to charge transaction charges based on type of the product e.g. they can decide not to charge it for debt schemes. However, the ‘opt-out’ shall be at distributor level and not investor level i.e. a distributor cannot charge one investor, and choose not to charge another investor.

Fees and Expenses

Investment and Advisory Fees are charged to the scheme by the AMC. The details of such fees are fully disclosed in the offer document. In addition to the aforementioned fees, two kinds of expenses come up in creating and managing a mutual fund:

- **Initial Issue expenses** are incurred at the time of launching a scheme in an NFO. It is a one-time expense. Schemes launched before the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2008 had to bear the initial issue expenses up to 6 percent of the amount mobilized. This has been discontinued and the initial issue expenses are now borne by the AMC.

- **Recurring Expenses** are the fund running expenses incurred to manage the money raised from the investors. These can be charged to the scheme. Since the recurring expenses drag down the NAV, SEBI has laid down the types of expenses, which can be charged to the scheme and the limits to such expenses.

An indicative list is as follows:

- Fees of various service providers, such as Trustees, Registrar & Transfer Agents, Custodian, & Auditor
- Brokerage and transaction cost
- Marketing and selling expenses including scheme advertising and commission to the distributors
- Expenses on statutory investor communication, fund transfer from location to location, providing account statements and dividend / redemption cheques / warrants
- Listing fees and Depository fees
- Insurance premium paid by the fund
- In case of Gold ETFs, the cost of storage and handling of gold, in case of Capital Protection funds, the cost of credit rating and in case of Real estate mutual funds, the cost of insurance premium and maintenance of real estate assets
- Winding up costs for terminating a fund or scheme

Expenses that are not permitted to be charged to the scheme shall be borne by the AMC or sponsors.

NISM Series V-A: Mutual Fund Distributors Certification Examination – Important Notes
o Penalties and fines for infraction of laws.
o Interest on delayed payment to the unit holders.
o Legal, marketing, publication and other general expenses not attributable to any scheme(s).
o Fund Accounting Fees.
o Expenses on investment management/general management.
o Expenses on general administration, corporate advertising and infrastructure costs.
o Depreciation on fixed assets and software development expenses.

Recurring Expense Limits

<table>
<thead>
<tr>
<th>Daily Net Assets (Rs crore)</th>
<th>Equity Schemes</th>
<th>Debt Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>On the first Rs. 100 crore of the daily net assets</td>
<td>2.50 percent</td>
<td>2.25 percent</td>
</tr>
<tr>
<td>On the next Rs 300 crore of the daily net assets</td>
<td>2.25 percent</td>
<td>2.00 percent</td>
</tr>
<tr>
<td>On the next Rs 300 crore of the daily net assets</td>
<td>2.00 percent</td>
<td>1.75 percent</td>
</tr>
<tr>
<td>On the balance of the assets</td>
<td>1.75 percent</td>
<td>1.50 percent</td>
</tr>
</tbody>
</table>

For FOF the total expenses should not exceed 0.75%
For Index Funds – 1.5%
Recurring Expenses includes Fund Management Fee also

Disclosure of Total Expense Ratio (TER)

- AMCs need to prominently disclose on a daily basis, the TER (scheme wise, date wise) of all schemes under a separate head – “Total Expense Ratio of Mutual Fund Schemes” on their website and on the website of AMFI in downloadable spreadsheet format
- Any changes in the base TER (i.e. TER excluding above mentioned additional expenses and Goods and Services Tax on investment and advisory fees) in comparison to the previous base TER charged to any scheme to be communicated to investors of the scheme through email or SMS at least three working days prior to effecting such change.

Valuation

The valuation of these securities to determine the net asset value has to be done in accordance with the valuation norms laid down by SEBI and AMFI. This includes the following norms:

- A traded security shall be valued at the last quoted closing price on the principle stock exchange where it is traded. Wherever a security, say, XYZ share, is traded in the market on the date of valuation, its closing price on that date is taken as the value of the security in the portfolio. Thus, the number of XYZ shares in the portfolio (say, 1,000) multiplied by its closing price (say, Rs 2,700), gives the valuation of XYZ shares in the portfolio (1,000 shares X Rs 2,700 = Rs 27,00,000).
- If the security is not traded on a particular date on any stock exchange, then the price at which it is traded on the principal stock exchange or any other stock exchange on the earliest previous day will be used for valuation provided such date is not more than 30 days prior to the valuation date for securities other than debt and not more than 15 days for debt securities (other than G-secs).
- When a debt security (other than G-secs) is purchased by way of private placement, the value at which it was bought may be used for a period of fifteen days beginning from the date of purchase. Similarly, every security in the portfolio has to be valued. All money market and debt instruments with residual maturity up to 60 days shall be valued at the weighted average price on the valuation date.
- Illiquid securities, defined as non-traded, thinly-traded and unlisted equity shares, shall not exceed 15 percent of the total assets of the scheme. Any excess over 15 percent shall be assigned zero value.
- The value of the gold held by a gold ETF will be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand.
• AMFI has appointed third party valuation agencies (currently CRISIL and ICRA) to provide security level pricing of fixed income securities with maturity greater than 60 days in order to achieve uniform valuation by all AMCs. Valuation of every security is the responsibility of the AMC and SEBI has only provided the principles of valuation.

**Taxation**

**Securities Transaction Tax (STT)**

When an investor sells units of an equity fund in the stock exchange, or offers them for re-purchase to the fund, he will have to incur Securities Transaction Tax (STT) i.e. STT is applicable only on redemption/switch to other schemes/sale of units of equity oriented mutual funds whether sold on stock exchange or otherwise. STT is not applicable on purchase of units of an equity scheme. It is also not applicable to transactions in debt securities or debt mutual fund schemes.

**STT applicability for Investors in Equity oriented Mutual funds**

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Rates (in percent)</th>
<th>Payable by:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase of units of equity oriented mutual fund</td>
<td>NIL</td>
<td>Purchaser</td>
</tr>
<tr>
<td>Sale of units of an equity oriented fund to the mutual fund</td>
<td>0.001</td>
<td>Seller</td>
</tr>
</tbody>
</table>

**Additional Tax on Income Distributed**

There is a tax on dividend distributed by mutual fund schemes (equity and debt) which is paid by the mutual fund. The dividend that the unit holders receive is however exempt from tax in the hands of the recipient.

Applicability of Dividend Distribution Tax (DDT) for FY 2018-2019 is as follows:

<table>
<thead>
<tr>
<th>Schemes</th>
<th>Individual/ HUF</th>
<th>Domestic Company</th>
<th>NRI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity oriented Scheme</td>
<td>10% + 12% Surcharge + 4% cess = 11.648%</td>
<td>10% + 12% Surcharge + 4% cess = 11.648%</td>
<td>10% + 12% Surcharge + 4% cess = 11.648%</td>
</tr>
<tr>
<td>Money Market or Liquid Schemes/Debt Schemes (other than Infrastructure Debt Fund)</td>
<td>25% + 12% Surcharge + 4% cess = 29.12%</td>
<td>30% + 12% Surcharge + 4% cess = 34.944%</td>
<td>25% + 12% Surcharge + 4% cess = 29.12%</td>
</tr>
<tr>
<td>Infrastructure Debt Fund</td>
<td>25% + 12% Surcharge + 4% cess = 29.12%</td>
<td>30% + 12% Surcharge + 4% cess = 34.944%</td>
<td>5% + 12% Surcharge + 4% cess = 5.824%</td>
</tr>
</tbody>
</table>

*Note: The surcharge mentioned above is calculated on the base tax; and the cess is calculated on the aggregate of base tax and surcharge.*

**Dividend Income:**

A tax of 10% (plus applicable surcharge and cess) is applicable for all resident tax payers (excluding domestic companies and few other specified entities) for dividend income of more than Rs. 10 lakh received from a domestic company (ies).

**Capital Gains Tax**

Capital Gain is the difference between sale price and acquisition cost of the investment. Since mutual funds are exempt from tax, the schemes do not pay any tax on the capital gains they earn.

Investors in mutual fund schemes however need to pay tax on their capital gains as follows:

<table>
<thead>
<tr>
<th>Equity-oriented schemes:</th>
<th>Individual/ HUF</th>
<th>Company</th>
<th>NRI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long Term Capital Gains* (units held for more than 12 months)</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Short Term Capital Gains (units held for 12 months or less)</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
</tr>
</tbody>
</table>

*As per the Finance Act 2018 Tax to be levied at the rate of 10% (without indexation benefit) on long-term capital gains exceeding Rs. 1,00,000 in a financial year provided transfer of such units is subject to Securities Transaction Tax. All capital gains upto January 31, 2018 have been grandfathered.
Debt-oriented schemes

<table>
<thead>
<tr>
<th>Long Term Capital Gains (units held for more than 36 months)</th>
<th>Individual/ HUF/ Company</th>
<th>NRI</th>
</tr>
</thead>
<tbody>
<tr>
<td>20% after indexation</td>
<td>Listed - 20% after indexation</td>
<td></td>
</tr>
<tr>
<td>Unlisted – 10% without indexation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Short Term Capital Gains (units held for 36 months or less)

- 30% (assuming the investor falls in the highest tax bracket)
- 30% (assuming the investor falls in the highest tax bracket)

**Indexation** means that the cost of acquisition is adjusted upwards to reflect the impact of inflation. The government comes out with an inflation index number for every financial year to facilitate this calculation. Indexation benefit is available only in case of long term capital gains and not short term capital gains. Tax is payable on long-term capital gains, after indexation, at 20 percent plus surcharge plus cess.

**TDS**

No Tax Deducted at Source (TDS) on dividend payments or re-purchase payments to resident investors. Withholding tax or TDS is applicable for non-resident investors.

**Setting off Capital Losses under Income Tax Act**

Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries).

- Short term capital loss is to be set off against short term capital gain or long term capital gain.
- Long term capital loss can only be set off against long term capital gain.

**CHAPTER 7: INVESTOR SERVICES (12 marks)**

**KYC Documents**

For the KYC process (for establishing proof of identity and address), the following documents are required:

- **Permanent Account Number (PAN) Card** with photograph is mandatory for all applicants except those who are specifically exempt from obtaining PAN. This serves as the proof of identity.

- **Proof of Address** such as Passport, Voter’s Id, Ration card, Driving License, bank account statement, utility bill and other specified documents. If address for communication and permanent address are different then documentary proofs have to be provided for both. The proof of address in the name of the spouse may be accepted.

**PAN Exempt Investments in Mutual Funds**

- Providing Permanent Account Number (PAN) is compulsory for all mutual fund investments. Exception has been made for Micro-SIPs i.e. SIPs where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000.

- Small investors investing upto Rs. 50,000 per mutual fund per financial year do not need to provide PAN Card. Rs. 50,000 is a composite limit for the small investor’s Micro-SIP and lump sum investments together.

- Instead of the PAN, the investors (including joint holders) can submit any one of the following PHOTO IDENTIFICATION documents for KYC verification:
  - **Proof of Address** such as Passport, Voter’s Id, Ration card, Driving License, bank account statement, utility bill

**Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)**

- To comply with the requirements of Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS) provisions, financial institutions, including mutual funds, are required to undertake due diligence process to identify foreign reportable accounts and collect such information as required under the said provisions and report the same to the US Internal Revenue Service/any other foreign government or to the Indian Tax
Authorities for onward transmission to the concerned foreign authorities. The application form requires information to be provided if the citizenship/nationality/place of birth/tax residency are places other than India for all categories of investors.

- The countries of tax residency and respective tax payer reference ID has to be provided. Once an investor is identified as covered under the said regulation, the entire investment value of all the folios held will be reported. The identity of the investors and their direct and indirect beneficiaries and controlling persons will be reported. If there is a change in the status of the investor after the information is first provided, then the same has to be reported to the mutual fund within 30 days.

**Demat Account**

- Dematerialisation is a process whereby an investor’s holding of investments in physical form (paper), is converted into a digital record. Benefit of holding investments in demat form is that investors’ purchase and sale of investments gets automatically added or subtracted from their investment demat account, without having to execute cumbersome paperwork. Settlement of most transactions in the stock exchange needs to be compulsorily done in demat form.

**Transactions with Mutual Funds**

- Fresh purchase or initial purchase of mutual fund units in a scheme can be made during the new fund offer (NFO) period or even subsequently in an open-ended scheme, during the open offer period. The mutual fund would need the completed application form with the prescribed documentation and the requisite investment amount, to allot an investment folio in the name of the investor.

- Application forms are available with offices of AMCs, distributors and Investor Service Centres (ISCs). They are also downloadable from the websites of the AMCs concerned.

**Filling the Application Form for Mutual Funds**

The information required to be provided in the application form are discussed below.

**Direct Plan and Regular Plan**

Investors have the option to invest (purchase or subscribe to mutual fund units) directly without routing the investment through a distributor (Direct Plan). In this case, the investor must mention “Direct” in the space provided in the application form for entering the AMFI Registration Number (ARN)/ Registered Investment Advisor (RIA) number.

**Unit Holder Information**

A mutual fund investment can have upto three holders. All the holders must be investors eligible to invest in a mutual fund. The folio is created in the name of the first holder who is the primary investor. All benefits of the investments such as dividends, redemption payments and tax benefits will go to the first holder.

**Minor as a unit holder**

An investment made for a minor (less than 18 years) is done through a guardian who complies with the KYC and PAN requirements and all other formalities as if the investment was for themselves. The guardian is typically a natural parent or court appointed legal guardian. The documents to establish the natural relationship/legal guardianship (notarized photocopy of the court order) has to be provided at the time of investment.

**POA as a unit holder**

Similarly, a folio operated under a Power of Attorney (PoA), requires the PoA holder and issuer to comply with the KYC and PAN requirements and a certified copy of the PoA to be submitted to the mutual fund before the holder can operate the folio. The grantor or investor can continue to operate the account despite granting a PoA. The PoA holder can conduct all transactions except make or change nominations.
Other KYC Details

FATCA and CRS Details

For applicants, including guardians, whose country of birth/citizenship/nationality/tax residency is other than India, the application requires additional information under Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS)

- Place/City of Birth, Country of Birth, Country of Citizenship/Nationality
- Is the investor’s Tax Residency/Country of Birth/Citizenship/Nationality other than India (Yes or No)
  - If yes, indicate all countries in which the investor is resident for tax purpose and the associated Tax ID number (Details of Country of Tax Residency and Tax Payer Reference ID).

Bank Account Details

It is mandatory for investors to provide the bank details of the sole/first holder of the folio in the application form. This includes the name of the bank where the account is held, the branch and the city, the account number, type of account (current, savings, NRO, NRE, FCNR and others), MICR code and IFSC details.

Investment Details

Investors have to make their choice of scheme, plan, option and payout option at the time of making the application. Each scheme will offer a regular plan where the investment is routed through a distributor and a direct plan where the applicant invests directly without the assistance of a distributor.

Payment Details

The details of the payment instrument the bank account through which the payment for the investments are being made has to be mentioned in the application form.

Unit Holding Option

Investors have the option to hold the units in physical mode or demat mode. If the units are to be held in a demat account then the details of the beneficiary account, name and ID of the depository participant (DP) has to be provided. The name(s), mode of holding, PAN details and bank account of the applicant will be verified against the depository data. A copy of the DP statement has to accompany the application to be able to verify the details of the account. The dividend and redemption proceeds will be paid out to the bank account linked to the demat account.

Nomination

The applicant can make a nomination in favour of a maximum of three nominees and indicate the percentage to each nominee. The nomination can be made at the time of application or subsequently at any time. A folio held by a single holder should have a nomination made in the application.

Minimum Investment

The Scheme Information Document (SID) and Key Information Memorandum (KIM) provide information on the minimum application amount. Typically, the limit may be higher for the initial investment required to initiate the folio and lower for subsequent purchases.

Additional Purchases

Once an investor has a folio with a mutual fund, subsequent investments with the same mutual fund do not call for the full application form and documentation. Only a transaction slip needs to be filled giving the folio number, and submitted with the requisite payment. A transaction slip can be used to make additional purchases in an open-ended scheme in which the investor has already invested. It can also be used to make fresh purchases in another scheme of the same mutual fund under the same folio.

NiSM Series V-A: Mutual Fund Distributors Certification Examination – Important Notes
**Online Transactions**

Investors can conduct their mutual fund transactions online. The investor is required to fill the requisite details in an application form. Based on this, the investor would be allotted a user name and password (Personal Identification Number – PIN). This can be used by the investor to make additional purchases of units in the mutual fund, or to request re-purchase of the units held in the mutual fund. Payment transactions are made through the internet banking facility provided by banks. Some mutual funds also enable payment through debit cards and cheques and DD for online transactions.

**Payment Mechanism for Purchase / Additional purchase**

Payments for mutual fund purchases need to be made through the banking channel modes that have been approved by the regulators.

**Cheque/Demand Draft (DD)**

Application forms for fresh investment/transaction slip for additional purchase is normally accompanied by cheque/demand draft drawn in favour of the scheme in which application is to be made.

The payment instrument should not be post-dated (except for future installments under SIP), and not stale (i.e. cheque date should not be more than 3 months older than the date on which the cheque is to be banked). Third-party cheques are not accepted.

**Electronic Modes of Payment**

The Digital Payment Mediums available include the following:

**Internet Banking**

Internet banking is the most commonly used digital payment service. Electronic Clearing Service (ECS) / Standing Instructions (SI) are a convenient form of investment in a SIP. On the specified date, each month, the bank will automatically transfer money from the investor’s account to the account of the mutual fund. **M-Banking** i.e. mobile banking has now become a convenient way for investment and transaction purpose.

**Unified Payment Interface (UPI)**

The UPI allows fund transfer between accounts through the mobile app. The users have to register for mobile banking facility to be able to use the app. There are many UPI apps available such as BHIM, SBI UPI app, HDFC UPI app, mBanking, PhonePe app, Aadhar app etc. which one can download on their phone. After the application (app) is downloaded a Virtual Payment Address (VPA) has to be created by going through an authentication process. This is like an email address and links the UPI app to the user’s bank account through the mobile phone registered with the bank.

**Aadhaar Enabled Payment Service (AEPS)**

AEPS allows bank to bank transaction using the Aadhaar number of the customer. The Aadhaar number has to be linked to the bank account to be able to use AEPS. The account holder can withdraw and deposit cash and transfer money to another account linked to the Aadhaar number. The AEPS uses the fingerprint of the individual as the password to authorize transactions and is thus a secure mode of transfer of funds.

**National Unified USSD Platform (NUUP)**

NUUP based mobile banking allows transactions even without a smartphone and internet. The code *99# dialed from the phone registered with a bank for a bank account allows transactions such as making payments, checking balances, fund transfers and getting a mini statement.
Cards
Cards are the most commonly used mode of digital payments. Debit cards are issued by banks to their account holders and allow card holders to carry out fund transactions linked to their bank account. Credit cards are issued by banks and other approved entities and allow credit card holders to use the card up to approved credit limits.

E-Wallets
E-Wallets are a virtual or digital version of the physical wallet. Money is loaded to the E-Wallet and used as required to make payments and transfer funds to other E-Wallets. MFs/AMCs shall ensure that total subscription through e-wallets for an investor is restricted to Rs.50,000/- per investor per financial year.

Application Supported by Blocked Amount (ASBA)
This is a facility where the investment application in a New Fund Offer (NFO) is accompanied by an authorization to the bank to block the amount of the application money in the investor’s bank account.

Cash Payments
Mutual funds usually do not accept cash. Small investors, who may not be tax payers and may not have PAN/bank accounts, such as farmers, small traders/businessmen/workers are allowed cash transactions for purchase of units in mutual funds to the extent of Rs. 50,000/- per investor, per mutual fund, per financial year.

Allotment of Units to the Investor
Since entry load is banned, units in an NFO are sold at the face value i.e. Rs. 10. So the investment amount divided by Rs. 10 would give the number of units the investor has bought.

In a bonus issue, the investor does not pay anything. The fund allots new units for free. Thus, in a 1:3 bonus issue, the investor is allotted 1 new unit (free) for every 3 units already held by the investor. Since the net assets of the scheme remain the same – only the number of units’ increases - the NAV will get reduced proportionately and the value of the investor’s holding does not change significantly as a result of the bonus issue.

Instant Access Facility (IAF)
IAF facilitates credit of redemption proceeds in the bank account of the investor on the same day of the redemption request. The MFs/AMCs can offer IAF only in Liquid schemes of the mutual fund. The monetary limit under the IAF is Rs.50,000 or 90% of latest value of investment in the scheme, whichever is lower. This limit is applicable per day per scheme per investor.

Cut-off Time

<table>
<thead>
<tr>
<th>Purchase – NON Liquid Funds</th>
<th>Time</th>
<th>NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 Lakhs</td>
<td>Till 3 PM</td>
<td>Same day NAV</td>
</tr>
<tr>
<td>Equal or Greater than 2 Lakhs</td>
<td>Anytime</td>
<td>NAV of Fund Realisation day</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Redemption – NON Liquid Funds, Any Amount, till 3 PM, Same Day NAV</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Purchase – LIQUID FUNDS</th>
<th>Time</th>
<th>NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund available for Utilization</td>
<td>Before 2 pm</td>
<td>Previous Day NAV</td>
</tr>
<tr>
<td>If Fund is not available for utilization on application date before 2 then the NAV previous to the date of Fund realization before 2 pm shall be applicable</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Redemption – LIQUID Funds</th>
<th>Time</th>
<th>NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any Amount</td>
<td>Till 3PM</td>
<td>NAV of the day immediately preceding the next business day</td>
</tr>
</tbody>
</table>
Time Stamping

- The precision in setting cut-off timing
- These points of acceptance have time stamping machines with tamper-proof seal. Opening the machine for repairs or maintenance is permitted only by vendors or nominated persons of the mutual fund. Such opening of the machine has to be properly documented and reported to the Trustees.
- For online transactions, the time as per the web server to which the instruction goes, is used in determining the NAV for sale / re-purchase transactions.

Investment Plans and Services

Growth, Dividend Payout and Dividend Re-Investment Options

Most mutual fund schemes offer two options – Dividend and Growth. A third option, which is possible, is the Dividend re-investment Option. These are different options within a scheme having the same portfolio. Therefore, the portfolio returns are the same for all three options. However, they differ in the structure of cash flows and income accruals for the unit-holder, and therefore, the Unit-holder’s taxability, number of units held and value of those units. The post-tax return from each of these options will therefore be different.

In a dividend payout option, the fund declares a dividend from time to time. Some schemes (liquid and debt funds with very short term maturity) even declare a dividend daily, subject to availability of profits. When a dividend is paid, the NAV of the units falls to that extent. Both debt and equity schemes need to pay a dividend distribution tax (DDT) on the dividend distributed. This tax payment too reduces the NAV.

In a dividend re-investment option, as in the case of dividend payout option, NAV declines to the extent of dividend and dividend distribution tax. The resulting NAV is called ex-dividend NAV. However, the investor does not receive the dividend in his bank account; the amount is re-invested in the same scheme and additional units are allotted to the investor.

In a growth option, dividend is not declared. Therefore, nothing is received in the bank account (unlike dividend payout option) and there is nothing to re-invest (unlike dividend re-investment option). In the absence of dividend, there is no question of dividend distribution tax. The NAV would therefore capture the full value of the portfolio gains.

Systematic Transactions

Systematic Investment Plan (SIP)

It is considered a good practice to invest regularly, particularly into volatile markets such as equity markets. SIP is an approach where the investor invests constant amounts at regular intervals. A benefit of such an approach, particularly in equity schemes, is that it averages the unit-holder’s cost of acquisition since more units are bought for the same amount of investment when the price/markets are down and fewer units when the price/markets are up. It is also called Rupee Cost Averaging

A new investor has to submit both the application form as well as the SIP enrollment form to register for an SIP. The information provided in both the forms have to tally. In case of an existing investor only the SIP enrollment form has to be submitted. The enrollment form requires the names, PAN and KYC compliance of all the holders of the folio and their signatures. For existing investors only, the folio number needs to be provided. The enrollment form has to be signed as per the mode of holding of the existing folio. The investment details to be provided in the form includes the scheme, plan and option selected. The SIP details to be provided are the SIP amount, frequency, SIP date and the start and end date for the SIP period. The details of the bank account that is registered for ECS/Direct Debit/Standing Instructions for the SIP should be provided in the form.
Systematic Withdrawal Plan (SWP)
Just as investors do not want to buy all their units at a market peak, they do not want to risk redeeming all their units in a market trough. Investors can therefore opt for the safer route of offering for re-purchase a constant value of units over a period of time.

Systematic Transfer Plan (STP)
This is a variation of SWP. While in a SWP the constant amount is paid to the investor at the prespecified frequency, in a STP, the amount that is withdrawn from a scheme (called the source scheme) is re-invested in some other scheme (called the target scheme) of the same mutual fund. Thus, it operates as a SWP from the source scheme, and a SIP into the target scheme. Since the investor is effectively switching between schemes, it is also called “switch” if it is just one transaction or tranche.

Dividend Transfer Plan (DTP)
Dividend Transfer Plan (DTP) is a facility that allows investors to invest the dividend earned in a mutual fund investment into another scheme of the same mutual fund.

Triggers
It is not uncommon for investors to rue missed opportunities of buying or selling because they could not give the requisite instructions in time. This is addressed through the trigger option that is offered by some mutual funds. For instance, an investor can book profits by specifying that the units would be re-purchased if the market reaches a particular level. In that case, once the market reaches that level, the units would be re-purchased, without the need for going through a separate re-purchase documentation. It stands to reason that if the market continues to go up after the trigger is activated, the investor loses on the further gain.

CHAPTER 8: RETURN, RISK AND PERFORMANCE OF FUNDS (10 Marks)

Drivers of Returns and Risk in a Scheme

Equity Schemes
Equity as an asset class represents growth investment. The returns to an investor are primarily from appreciation in the value of the asset.
There are two broad approaches to security analysis: fundamental analysis and technical analysis.

Fundamental Analysis entails review of the company’s fundamentals viz. financial statements, quality of management, competitive position in its product / service market etc. The analyst sets price targets, based on financial parameters. Some of these financial parameters are listed below:

Earnings per Share (EPS): Net profit after tax ÷ No. of equity shares outstanding
This tells investors how much profit the company earned for each equity share that they own.

Price to Earnings Ratio (P/E Ratio): Market Price per share ÷ Earnings Per Share (EPS)
When investors buy shares of a company, they are essentially buying into its future earnings. P/E ratio indicates how much investors in the share market are prepared to pay (to become owners of the company), in relation to the company’s earnings. The forward PE ratio is normally calculated based on a projected EPS for a future period (also called forward EPS)

Book Value per Share: Net Worth ÷ No. of equity shares outstanding
This is an indicator of how much each share is worth, as per the company’s own books of accounts. The accounts represent a historical perspective, and are a function of various accounting policies adopted by the company.

Price to Book Value: Market Price per share ÷ Book Value per share
An indicator of how much the share market is prepared to pay for each share of the company, as compared to its book value. The drawback with this is that the book value is an accounting measure and may not represent the true value of the assets of the company.

**Dividend Yield:** Dividend per share ÷ Market price per share
This is used as a measure of the payouts received from the company, in percentage, for each rupee of investment in the share. Since dividends are not guaranteed or fixed, investors who are particular about receiving payouts look at the trend in dividend yields over a period of time. Dividend yield is considered as a parameter by conservative investors looking to identify steady and lower risk equity investments.

The discipline of **Technical Analysis** has a completely different approach. Technical Analysts believe that price behaviour of a share over a period of time throws up trends for the future direction of the price. Along with past prices, the volumes traded indicate the underlying strength of the trend and are a reflection of investor sentiment, which in turn will influence future price of the share. Technical Analysts therefore study price-volume charts (a reason for their frequently used description as “chartists”) of the company’s shares to decide support levels, resistance levels, break outs, and other triggers to base their buy/sell/hold recommendations for a share.

**Investment Styles – Growth and Value**

*Growth investment style* entails investing in high growth stocks i.e. stocks of companies that are likely to grow much faster than the market.

*Value investment style* is an approach of picking up stocks, which are priced lower than their intrinsic value, based on fundamental analysis.

**Portfolio building approach – Top down and Bottom up**

In a **top down** approach, the portfolio manager evaluates the impact of economic factors first and narrows down on the industries that are suitable for investment. Thereafter, the companies are analysed and the good stocks within the identified sectors are selected for investment.

A **bottom-up** approach on the other hand analyses the company-specific factors first and then evaluates the industry factors and finally the macro-economic scenario and its impact on the companies that are being considered for investment. Stock selection is the key decision in this approach; sector allocation is a result of the stock selection decisions.

**Debt**

Investment in a debt security, entails a return in the form of interest (at a pre-specified frequency for a pre-specified period), and repayment of the invested amount at the end of the pre-specified period. The pre-specified period is called **tenor.** At the end of the tenor, the securities are said to **mature.** The process of repaying the amounts due on maturity is called **redemption.** Debt securities that are to mature within a year are called money market securities.

Debt securities may be issued by Central Government, State Governments, Banks, Financial Institutions, Public Sector Undertakings (PSU), Private Companies, Municipalities, etc.

- Securities issued by the Government are called Government Securities or G-Sec or Gilt.
- Treasury Bills are short term debt instruments issued by the Reserve Bank of India on behalf of the Government of India.
- Certificates of Deposit are issued by Banks (for 7 days to 1 year) or Financial Institutions (for 1 to 3 years)
- Commercial Papers are short term securities (upto 1 year) issued by companies.
- Bonds / Debentures are generally issued for tenors beyond a year. Governments and public sector companies tend to issue bonds, while private sector companies issue debentures.
Since the government is unlikely to default on its obligations, Gilts are viewed as safe as there is no credit risk associated with them. The yield on Gilt is generally the lowest in the market for a given tenor. Since non-Government issuers can default, they tend to offer higher yields for the same tenor. The difference between the yield on Gilt and the yield on a non-Government Debt security is called its credit spread (yield spread). The returns in a debt portfolio are largely driven by interest rates and credit spreads.

**Interest Rates**
Suppose an investor has invested in a debt security that yields a return of 8 percent. Subsequently, yields in the market for similar securities rise to 9 percent. It stands to reason that the security, which was bought at 8 percent yield, is no longer such an attractive investment. It will therefore lose value. Conversely, if the yields in the market go down, the debt security will gain value. Thus, there is an inverse relationship between yields and value of such debt securities, which offer a fixed rate of interest.

**Credit Spreads**
Suppose an investor has invested in the debt security of a company. Subsequently, its credit rating improves. The market will now be prepared to accept a lower credit spread. Correspondingly, the value of the debt security will increase in the market.

Benchmarking is a form of relative returns comparison. It helps in assessing under-performance or out-performance. Choice of benchmark depends on scheme type, choice of investment universe, choice of portfolio concentration and the underlying exposure.

**Benchmark for Equity Schemes**
SENSEX, S&P CNX Nifty, BSE 100

**Benchmark for Debt Schemes**
NSE’s MIBOR, CRISIL LiquiFEX for Liquid Schemes
Gilt Schemes Si-Bex (1 to 3 years), Mi-Bex (3 to 7 years) & Li-Bex (more than 7 years)

Gold is a truly international asset, whose quality can be objectively measured. The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.

Unlike gold, which is a global asset, real estate is a local asset. It cannot be transported – and its value is driven by local factors.

SEBI guidelines govern disclosures of return by mutual fund schemes. Loads and taxes pull the investor’s returns below that earned by the Scheme. Investor returns are also influenced by various actions of the investor himself.

**Measures of Returns**

**Simple Return**
Suppose you invested in a scheme at a NAV of Rs. 12. Later, you found that the NAV has grown to Rs. 15. How much is your return?

The Simple Return can be calculated with the following formula:

\[(\text{Later Value}-\text{Initial value}) \times 100/\text{Initial value} \]

\[(15-12)*100/12 = 25\%

simple return is simply the change in the value of an investment over a period of time.

**Annualized Return**
Two investment options have indicated their returns since inception as 5 percent and 3 percent respectively. If the first investment was in existence for 6 months, and the second for 4 months, then the two returns are obviously not comparable. Annualisation helps us compare the returns of two different time periods.

The Annualized Return can be calculated as:

\[(\text{Simple return} \times 12)/\text{period of simple returns (in months)}\]
Compounded Return

If the two investment options mentioned above were in existence for 6 years and 4 years respectively, then it is not possible to calculate the annualised return using the above formula as it does not consider the effect of compounding.

Suppose you deposited Rs. 10,000 in a cumulative bank deposit for 3 years at 10 percent interest, compounded annually.

The bank would calculate the interest in each of the 3 years as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Opening Balance</th>
<th>Interest (10 percent on opening)</th>
<th>Closing Balance (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10000</td>
<td>1000</td>
<td>11,000</td>
</tr>
<tr>
<td>2</td>
<td>11000</td>
<td>1100</td>
<td>12,100</td>
</tr>
<tr>
<td>3</td>
<td>12100</td>
<td>1210</td>
<td>13,310</td>
</tr>
</tbody>
</table>

Thus, at the end of the 3 year period, your principal of Rs. 10,000 would have grown to Rs. 13,310. If, on the other hand, the bank had calculated interest on simple basis, it would have calculated interest at Rs. 1,000 for each of the 3 years, and given you Rs. 13,000.

SEBI Norms regarding Representation of Returns by Mutual Funds in India

Mutual funds are not permitted to promise any returns, unless it is an assured returns scheme. Assured returns schemes call for a guarantor who is named in the offer document. The guarantor will need to write out a cheque, if the scheme is otherwise not able to pay the assured return. Advertisement Code and guidelines for disclosing performance related information of mutual fund schemes are prescribed by SEBI. The same has been discussed in earlier.

Drivers of Risk in a Scheme

Portfolio Risk

Investors invest in a mutual fund scheme, which in turn invests in the market – debt, equity, gold or real estate in varying mixes, depending on the nature of the scheme. There is no certainty regarding the performance of the market/s, where a fund invests. Valuation in the market may go up or go down. Accordingly, the value of the portfolio and the NAV of the scheme fluctuate.

Portfolio Liquidity

When investments are liquid, there is a transparent market benchmark to its value. Further, these investments can be sold easily if it is expected to perform poorly, or to book profits or to generate liquidity for the scheme. SEBI has therefore laid down criteria to identify illiquid investments, and also set a ceiling to the proportion of such illiquid investments in the net assets of a scheme. The prescribed ceiling is lower for open-ended scheme, which have a greater need for liquidity because investors can offer their units for re-purchase at any time.

Use of Derivatives

Mutual funds are permitted to use derivatives for hedging against risk or re-balancing the portfolio, but not for leveraging.

Unit-holder Churn

If an investor in an open-ended scheme offers his units for re-purchase, then the scheme needs to pay the investor. When such re-purchases go beyond the level of liquid assets, the scheme is forced to sell investments in its portfolio to generate the liquidity.
There have been occasions where institutional investors have suddenly offered a large number of units for re-purchase during difficult market conditions. The liquidity pressures force the scheme to sell assets below their intrinsic value. Consequently, retail investors suffer for no fault of theirs.

Mutual fund investors need to be cautious about schemes where the unit-holding is not widely distributed. As a measure to protect the investor, SEBI has stipulated the 20:25 rule viz. every scheme should have at least 20 investors; no investor should represent more than 25 percent of net assets of a scheme.

Risks in mutual fund schemes would depend on the nature of portfolio, its liquidity, outside liabilities and composition of unitholders. Fluctuation in returns is a measure of risk. Variance and Standard Deviation are risk measures for all kinds of schemes; beta is relevant for equity; modified duration and weighted average maturity are applicable for debt schemes.

The modified duration measures the sensitivity of value of a debt security to changes in interest rates. Higher the modified duration, higher is the interest sensitive risk in a debt portfolio.

Beta measures the fluctuation in periodic returns in a scheme, as compared to fluctuation in periodic returns of a diversified stock index (representing the market) over the same period. The diversified stock index, by definition, has a Beta of 1. Companies or schemes, whose beta is more than 1, are seen as more risky than the market. Beta less than 1 is indicative of a company or scheme that is less risky than the market.

Standard deviation is a measure of total risk in an investment. As a measure of risk it is relevant for both debt and equity schemes. A high standard deviation indicates greater volatility in the returns and greater risk.

Variance measures the fluctuation in periodic returns of a scheme, as compared to its own average return.

Quantitative Measures of Fund Manager Performance

Absolute & Relative Returns
In the section on calculation of returns, the focus was on absolute returns i.e. returns earned by the scheme. Having understood the concept of benchmarks, one can also do relative comparison viz. how did a scheme perform vis-à-vis its benchmark or peer group. Such comparisons are called relative return comparisons.
If a comparison of relative returns indicates that a scheme earned a higher return than the benchmark, then that would be indicative of outperformance by the fund manager. In the reverse case, the initial premise would be that the fund manager under-performed. Such premises of outperformance or under-performance need to be validated through deeper performance reviews.

Sharpe Ratio, Treynor Ratio and Alpha are bases to evaluate a fund manager’s performance based on risk-adjusted returns.

Sharpe Ratio: An investor can invest with the government and earn a risk-free rate of return. Through investment in a scheme, a risk is taken, and a return is earned. The difference between the two returns i.e. Rs– Rf is called risk premium. It is like a premium that the investor has earned for the risk taken, as compared to government’s risk-free return. This risk premium is to be compared with the risk taken. Sharpe Ratio uses Standard Deviation as a measure of risk.

Treynor Ratio: Computation of risk premium is the same as was done for the Sharpe Ratio. However, for risk, Treynor Ratio uses Beta. Higher the Treynor Ratio, better the scheme is considered to be. Since the concept of Beta is more relevant for diversified equity schemes, Treynor Ratio comparisons should ideally be restricted to such schemes.

ALPHA: The difference between a scheme’s actual return and its optimal return is its Alpha – a measure of the fund manager’s performance. Alpha, therefore, measures the performance of the investment in comparison to a suitable
market index. Positive alpha is indicative of out-performance by the fund manager; negative alpha might indicate under-performance.

CHAPTER 9: MUTUAL FUND SCHEME SELECTION (10 marks)

The selection of a mutual fund scheme for an investor will depend upon the need that the investor has from the investment. The investor may need long term appreciation in the value of his investment, or the investor may need periodic income from the investment, or the investor may be looking for an avenue to park funds and need an investment with high liquidity. It is considered a good practice to first understand the risk exposure that is appropriate for an investor. Based on that, decide how the investor’s investments should be distributed between different asset classes.

As a structured approach, the sequence of decision making is as follows:

- **Step 1** – Deciding on the asset class such as equity, debt, gold and others, based on the investor’s need for growth, income or liquidity.
- **Step 2** – Selecting a scheme category based on strategy and style within the scheme type, based on the risk taking ability of the investor. For example, large-cap or mid-cap funds, diversified or focused funds, short-term or long-term debt funds each have different risk and return features.
- **Step 3** – Selecting a particular scheme from a category based on its performance.
- **Step 4** – Selecting the right option within the scheme.

**How to choose between Scheme Categories?**

The investor’s need from the investment will determine the asset class that is the most suitable for the investor. An investor looking for growth will find equity the best suited to meet their needs. The need for income will be best met by a debt scheme, an investor who wants regular income will look at a hybrid fund such as a Monthly Income Plan.

At the next level, investors must select the product category based on the strategy and style adopted. Each of them have a different risk and return characteristics. An investor who wants to invest in low risk equity will consider an index fund or a value fund. On the other hand, an investor willing to take additional risk for better returns will choose a growth fund. An investor in debt who wants better returns will consider an Income fund or a long-term gilt fund, if they have a view that interest rates will decline.

**Active or Passive**

An investor in an active fund is bearing a higher cost for the fund management, and a higher risk to earn returns better than the benchmark. The returns ought to be higher i.e. the scheme should beat the benchmark, to make the investor believe that choice of active scheme was right. Index funds are passive funds. They are expected to offer a return in line with the market because they invest in a portfolio that mimics a market index in the securities it invests in and in the weightages allotted to each security in the portfolio. There is no selection risk in index funds because the fund manager has no role in creating the portfolio.

**Open-ended or Close-ended**

**Diversified, Sector or Thematic**

**Large-cap v/s Mid-cap / Small Cap Funds**

**Growth or Value funds**

**International Equity funds**

When an Indian investor invests in equities abroad, he is essentially taking two exposures:

- An exposure on the international equity market.
- An exposure to the exchange rate of the rupee. If the investor invests in the US, and the US Dollar becomes stronger during the period of his investment, he benefits; if the US Dollar weakens (i.e. Rupee becomes stronger), he loses or the portfolio returns will be lower.
Monthly Income Plans (MIPs)

Fixed Maturity Plans (FMPs)

FMP is ideal when the investor’s investment horizon is in sync with the maturity of the scheme, and the investor is looking for a more predictable return than any conventional debt scheme, and a return that is generally superior to what is available in a fixed deposit.

Diversified Debt Funds

Diversified debt funds or income funds invest in a mix of government securities (which are safer with respect to the risk of default) and non-government securities (which offer higher yields, but are subject to credit risk).

Short Term Debt Fund

Short-term debt funds, also called Short Duration Funds, invest in securities with maturities between 1 year and 3 years. As such they earn returns in line with the market yields. Some funds may take a small exposure to longer term securities to benefit from a gain in value if interest rates are expected to decline.

Liquid Schemes

Floating Rate Funds

Hybrid Schemes

How to select a Scheme within a Scheme Category?

Some parameters that are considered while selecting schemes within a category are as follows:

Fund Performance

The fund’s performance is a primary criterion in its selection from amongst other schemes. The returns that the fund has generated relative to its benchmark are evaluated over a period of time. The fund should ideally have consistently outperformed the benchmark. Not only should it have outperformed in a bull market, but in a falling market it should have been able to protect the downside.

Fund Portfolio

- The fund’s portfolio has to be evaluated to determine the risk and return in the scheme. In case of equity funds, the level of diversification across sector and stocks, the market segment in which the fund invests, the extent of cash held and the conviction showed in terms of the length of holding in stocks and churn in the portfolio, the strategy adopted for selecting securities for the portfolio and managing it, have to be considered.
- In case of debt funds, the average maturity and duration of the portfolio, the credit risk profile, the contribution of interest and capital gains to the total returns of the fund, liquid holding in the portfolio, need to be evaluated before making an investment decision.

Fund Age

A fund with a long history has a track record that can be studied. A new fund managed by a portfolio manager with a lacklustre track-record is definitely avoidable.

Fund Size

The size of funds needs to be seen in the context of the proposed investment universe. For an equity fund that intends to invest in large cap stocks, a large fund size will be an advantage, while for a sector fund or a mid-cap fund with limited investment options, a large fund size may be a disadvantage. A large fund size will allow better diversification and economies of scale. A small sized fund on the other hand is more flexible and better able to take advantage of market opportunities.

Portfolio Turnover
Purchase and sale of securities entails broking costs for the scheme. Frequent churning of the portfolio would not only add to the broking costs, but also be indicative of unsteady investment management.

**Scheme running expenses**

- Any cost is a drag on investor’s returns. Investors need to be particularly careful about the cost structure of debt schemes, because in the normal course, debt returns can be much lower than equity schemes. Similarly, since index funds follow a passive investment strategy, a high cost structure is questionable in such schemes.
- Quarterly performance ranking of schemes over a period of time shows that the best ranking fund in a quarter is not necessarily the best ranking fund in the next quarter.
- The investor also needs to remember that beyond performance of the scheme, loads make a difference to the investor’s return.

**Other IMPORTANT points:**

- While investing in equity funds, a principle to internalize is that markets are more predictable in the long term, than in the short term. So, it is better to consider equity funds, when the investment horizon is adequately long.
- It can be risky to invest in mid-cap / small cap funds during periods of economic turmoil. As the economy recovers, and investors start investing in the market, the valuations in front-line stocks turn expensive. At this stage, the mid-cap / small cap funds offer attractive investment opportunities. Over longer periods, some of the mid/small cap companies have the potential to become large cap companies thus rewarding investors.
- The comparable for a liquid scheme in the case of retail investors is a savings bank account. Switching some of the savings bank deposits into liquid schemes can improve the returns for him.
- Businesses, which in any case do not earn a return on their current account, can transfer some of the surpluses to liquid schemes.
- Debt investors would ensure that the weighted average maturity of the portfolio is in line with their view on interest rates.
- Investors in non-gilt debt schemes will keep an eye on credit quality of the portfolio – and watch out for sector concentration in the portfolio, even if the securities have a high credit rating.
- Any cost is a drag on investor’s returns. Investors need to be particularly careful about the cost structure of debt schemes. SEBI legislations prescribe a maximum exit load of 7%.
- Significant Unit holder means any entity holding 5% or more of the total corpus of any scheme.
- Maximum investment per investor is limited to 25% of the Net Assets of the scheme.
- A scheme should have a minimum of 20 investors at any point of time.
- MF can borrow only to meet Redemption / Liquidity needs. Borrowing is limited to 20% of Net Assets for a Max Period of 6 months. However MF cannot invest Borrowed amount
- Amongst index schemes, tracking error is a basis to select the better scheme. Lower the tracking error, the better it is.
- Mutual fund research agencies assign a rank to the performance of each scheme within a scheme category (ranking). Some of these analyses cluster the schemes within a category into groups, based on well-defined performance traits (rating).

**Which is the Better Option within a Scheme?**

Dividend payout, dividend re-investment and growth options

- Dividend payout option has the benefit of money flow to the investor; growth option has the benefit of letting the money grow in the fund on gross basis (i.e. without annual taxation).
- The dividend payout option seems attractive for investors wanting a regular income. Dividend reinvestment option neither gives the cash flows nor allows the money to grow in the fund on gross basis. Taxation and liquidity needs are a factor in deciding between the options.
CHAPTER 10: SELECTING THE RIGHT INVESTMENT PRODUCTS FOR INVESTORS (9 marks)

Savings and Investment

Saving refers to the excess income available to an individual or household after meeting current expenses. These are the funds available to be apportioned to future needs that are referred to as financial goals. One way of doing this is to put the savings to work by investing it. Investing is the term used to describe the activity of employing available funds in suitable investment opportunities in physical and financial products with the intent of earning a return. The returns or gains made from investing are also then available to help meet the goals.

Inflation Risk

Inflation risk represents the risk that the money received on an investment may be worth less when adjusted for inflation. Inflation risk is also known as purchasing power risk. It is the risk that arises from the decline in value of security’s cash flows due to the falling purchasing power of money.

A bond pays 10% interest per annum. The inflation rate for that year is 5%. What is the real return?

Nominal rate of return= 10%
Inflation rate= 5%
Real rate of return = 10% - 5% = 5%

The nominal return is always a positive rate, because investors have to be paid a positive rate to invest their money. But the real rate can be negative or positive. If inflation rate is higher than nominal rate of return, then that results in a negative real return. A negative real return implies that the return earned has been wiped out by rising prices.

Gold – Physical or Financial?

Gold suffers one of the highest risks of loss through theft. Storage in bank lockers too costs money. The exposure to gold as a financial asset can be taken in different forms:

- Gold ETF
- Gold Sector Fund
- Gold futures contracts are traded in commodity exchanges like the National Commodity and Derivatives Exchange (NCDEX). The value of these contracts goes up or down in line with increases or decreases in gold prices.

Gold ETF on the other hand is an open-ended scheme with no fixed maturity. It is very rare for an open-ended scheme to liquidate itself early. Therefore, an investor who buys into a gold ETF can hold the position indefinitely.

Real Estate – Physical or Financial?

- The ticket size i.e. the minimum amount required for investing in real estate is high. The investment would run into lakhs of rupees, even to buy agricultural land.
- Unless the budget is very high, and the value of properties bought are very low, investors would find it difficult to maintain a diverse portfolio of real estate. Thus, they end up with concentration risk.
- Real estate is an illiquid market.
- Once a deal is executed, the transaction costs, such as stamp duty and registration charges, are also high.

It is for these reasons that real estate investors prefer to invest through Real Estate Mutual Funds. The ticket sizes are flexible; further professional managers of the real estate portfolio are in a better position to manage the other risks and issues associated with real estate investment.

Using Mutual Funds to Meet Investor Goals

- Mutual fund debt schemes are superior to bank deposits in the following respects: With a bank deposit, the depositor can never earn a return higher than the interest rate promised. In a mutual fund scheme, no return is guaranteed – however it is possible to earn market returns. Fund managers manage the portfolio to generate the best returns possible given the market conditions.
Active investors can use debt funds to earn returns on their debt portfolio when interest rates are rising and falling. Short-term debt funds help earn higher interest income in a rising interest rate scenario. Long-term debt funds help investors earn higher returns from capital gains in falling interest rate scenarios.

Interest earned in a bank deposit is taxable each year. However, if a unit holder allows the investment to grow in a mutual fund scheme (which in turn is exempt from tax), then no income tax is payable on year to year accretions.

An investor looking for regular income, such as in retirement, invests in the Post office Monthly Income Scheme (MIS) or the Senior Citizen Savings Schemes (SCSS) for guaranteed income, among others. Both these schemes have an upper limit for investment which limits the amount of income that can be earned from them as well as fixed tenure after which they have to be renewed. The Monthly Income Plan (MIP) of mutual funds are debt oriented hybrid schemes that take some exposure to equity to provide a regular income to the investors. There is no upper limit on the investment that can be made in the scheme and they are open-ended scheme. Though there is no guarantee on the income, there are schemes that have a history of uninterrupted dividend payment for the investor.

Equity investing requires research, analysis, monitoring and rebalancing to ensure that the investor’s equity portfolio outperforms the benchmark. This requires the skill and time that most investors may not have. Moreover, a diversified portfolio is essential to manage the risk in equity investing. Individual investors may not have the corpus necessary to effectively diversify into sectors and stocks. An equity fund is a professionally managed portfolio. Apart from an experienced fund manager who makes the fund management decisions, the selection and rebalancing of the portfolio is supported by a research and analysis team.

Investors have multiple saving products such as NSC, PPF, Bank deposits and others which enable them to save tax under section 80 C of the Income Tax Act. These products are debt investments, and while they may provide guaranteed returns they do not provide the capital appreciation that will effectively beat inflation. Equity Linked Savings Schemes (ELSS) are equity mutual funds that are also permitted investments under section 80 C. Along with tax savings, they provide capital appreciation linked to equity investments.

Accumulating the corpus for retirement has conventionally been done through products such as employee provident funds, public provident fund and other debt-oriented investments. Given the long investment horizon for the retirement goal, the investor can take some exposure to equity to optimize the returns from the money being accumulated.

**National Pension System (NPS)**

Pension Funds Regulatory and Development Authority (PFRDA) is the regulator for the National Pension System. Two kinds of pension accounts are offered:

- Tier I account which is a pension account with limited withdrawal facility.
- Tier II (Savings account) is withdrawable to meet financial contingencies. An active Tier I account is a pre-requisite for opening a Tier II account.

Investors can invest through Points of Presence (POP). They can allocate their investment between 4 kinds of asset classes

1. **Asset Class E**: Investment in predominantly equity market instruments
2. **Asset Class C**: Investment in Debt securities other than Government Securities
3. **Asset Class G**: Investments in Government Securities
4. **Asset Class A**: Investments in Alternative Investment Products

NPS offers the convenience of a single Permanent Retirement Account Number (PRAN), which is applicable across all the Pension Fund Managers where the investor’s money is invested. PRAN is a unique ID number for NPS investments and it is portable.
CHAPTER 11: HELPING INVESTORS WITH FINANCIAL PLANNING (7 marks)

Financial planning is a planned and systematic approach to provide for the financial goals that will help people realise their aspirations, and feel happy. The costs related to financial goals, in today’s terms, need to be translated into the rupee requirement in future. This is done using the formula $A = P \times (1 + i)^n$ (future value formula)

The objective of financial planning is to ensure that the right amount of money is available at the right time to meet the various financial goals of the investor. An objective of financial planning is also to let the investor know in advance, if some financial goal is not likely to be fulfilled. A “goal-oriented financial plan” is a financial plan for a specific goal. An alternate approach is a “comprehensive financial plan” where all the financial goals of a person are taken together, and the investment strategies worked out on that basis

The steps in creating a comprehensive financial plan, as proposed by the Certified Financial Planner – Board of Standards (USA) are as follows:

- Establish and Define the Client-Planner Relationship
- Gather Client Data, Define Client Goals
- Analyse and Evaluate Client’s Financial Status
- Develop and Present Financial Planning Recommendations and/or Options
- Implement the Financial Planning Recommendations
- Monitor the Financial Planning Recommendations

**Life Cycle and Wealth Cycle in Financial Planning**

**Life Cycle**

These are the normal stages that people go through, viz.:

**Childhood**

During the childhood stage, focus is on education in most cases. Children are dependents, rather than earning members. Investments made from such sources are typically for the long-term, which makes equity investments viable.

**Young Unmarried**

- The earning years start in the ‘Young’ unmarried stage. At this stage income is likely to be limited while expenses are likely to be high. It is good to get into the habit of saving and a budget may be a good idea to control expenses.
- This is the right age to start investing in equity for the long term goals. Personal plans on marriage, transportation and residence determine the liquidity needs. Those who wish to buy a car/two-wheeler or house may prefer to invest more in relatively liquid investment avenues suitable for the shorter investment horizon.

**Young Married**

- A cushion of assets created during the early earning years can be a huge confidence booster while taking up the responsibilities associated with marriage. Where both spouses have decent jobs, life can be financially comfortable. They can plan where to stay in/buy a house, based on job imperatives, lifestyle aspirations and personal comfort.
- Insurance is required and there is a greater ability to take risks with investment.
- Expenses are likely to be high at this stage. But with careful planning it is possible to save money.

**Married with Young Children**

- Insurance needs – both life and health - increase with every child. The financial planner is well placed to advise on a level of insurance cover, and mix of policies that would help the family maintain their lifestyle in the event of any contingency. Expenses for education right from pre-school to normal schooling to higher education is growing much faster than regular inflation.
- Adequate investments are required to cover this. Long-term goals of education, retirement can see allocations being made to equity. Medium term goals like a down payment on a house or foreign holiday can see investments being made in debt.
**Married with Older Children**

- The costs associated with helping the children settle i.e. cost of housing, marriage etc. are shooting up. If investments in growth assets like shares and real estate, are started early in life, and maintained, it would help ensure that the children enjoy the same life style, when they set up their independent families. At this stage, as goals for which the person has been accumulating comes closer, funds will be moved from volatile assets such as equity to more stable debt investments.

**Pre-Retirement**

By this stage, the children should have started earning and contributing to the family expenses. Further, any loans taken for purchase of house or car, or education of children should have been extinguished. The family ought to plan for their retirement – what kind of lifestyle to lead, and how those regular expenses will be met.

**Retirement**

At this stage, the family should have adequate corpus, the interest on which should help meet regular expenses. The need to dip into capital should come up only for contingencies – not to meet regular expenses. The availability of any pension income and its coverage (only for the pensioner or extension to family in the event of death of pensioner) will determine the corpus requirement. Besides the corpus of debt assets to cover regular expenses, there should also be some growth assets like shares, to protect the family from inflation during the retirement years.

**Wealth Cycle**

This is an alternate approach to profile the investor. The stages in the Wealth Cycle are:

**Accumulation**

This is the stage when the investor gets to build his wealth. It covers the earning years of the investor i.e. the phases of the life cycle from Young Unmarried to Pre-Retirement.

**Transition**

Transition is a phase when financial goals are in the horizon. E.g. house to be purchased, children’s higher education / marriage approaching etc. Given the impending requirement of funds, investors tend to increase the proportion of their portfolio in liquid assets viz. money in bank, liquid schemes etc.

**Inter-Generational Transfer**

During this phase, the investor starts thinking about orderly transfer of wealth to the next generation, in the event of death. The financial planner can help the investor understand various inheritance and tax issues, and help in preparing Will and validating various documents and structures related to assets and liabilities of the investor. It is never too early to plan for all this. Given the consequences of stress faced by most investors, it should ideally not be postponed beyond the age of 50.

**Reaping / Distribution**

This is the stage when the investor needs the funds that have been accumulated over time. Hence, investors in this stage would move the funds to asset classes that meet their need for easy access to funds or regular periodic income as the case may be. It is the parallel of retirement phase in the Life Cycle.
CHAPTER 12: RECOMMENDING MODEL PORTFOLIOS AND FINANCIAL PLANS (8 marks)

Need for Risk Profiling

Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments. The investment advice is dependent on understanding both aspects of risk:

- Risk appetite of the investor
- Risk level of the investment options being considered.

Factors that Influence the Investor’s Risk Profile

Some of the factors and their influence on risk appetite are as follows:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Influence on Risk Appetite</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earning Members</td>
<td>Risk appetite increases as the number of earning members increases</td>
</tr>
<tr>
<td>Dependent Members</td>
<td>Risk appetite decreases as the number of dependent members increases</td>
</tr>
<tr>
<td>Life expectancy</td>
<td>Risk appetite is higher when life expectancy is Longer</td>
</tr>
<tr>
<td>Age</td>
<td>Lower the age, higher the risk that can be taken</td>
</tr>
<tr>
<td>Employability</td>
<td>Well qualified and multi-skilled professionals can afford to take more risk</td>
</tr>
<tr>
<td>Nature of Job</td>
<td>Those with steady jobs are better positioned to take risk</td>
</tr>
<tr>
<td>Capital base</td>
<td>Higher the capital base, better the ability to financially take the downsides that come with risk</td>
</tr>
<tr>
<td>Regularity of Income</td>
<td>People earning regular income can take more risk than those with unpredictable income streams</td>
</tr>
</tbody>
</table>

Asset Allocation

Don’t put all your eggs in one basket’ is an old proverb. It equally applies to investments.

Asset Allocation Types

- Strategic Asset Allocation is the ideal that comes out of the risk profile of the individual.
- Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market.
- Financial planners often work with model portfolios – the asset allocation mix that is most appropriate for different risk appetite levels. The financial planner would have a model portfolio for every distinct client profile.

Asset Allocation Video - https://www.youtube.com/watch?v=KjdIf1zA6wU

Model Portfolio

Young call centre / BPO employee with no dependents
1. 50% in Diversified Equity Funds through SIP
2. 20% in Sector Fund, 10% each in Gold ETF, Diversified Debt, Liquid.

Young married single income family with two school going kids
1. 35% diversified equity schemes; 15% in gold ETF,
2. 30% diversified debt fund, 10% each in Sector and liquid schemes

Single income family with grown up children who are yet to settle
1. 35% diversified equity schemes; 20% liquid schemes
2. 15% each in gold ETF, gilt fund & diversified debt fund

Couple in their seventies, with no immediate family support
1. 15% diversified equity index scheme; 10% gold ETF
2. 30% gilt fund, 30% diversified debt fund, 15% liquid schemes
Couple in their seventies, with no immediate family support but very sound physically and mentally, & a large investible corpus

1. 20% diversified equity scheme; 10% diversified equity index scheme;
2. 10% each in Gold ETF & Liquid, 25% each in gilt & diversified debt fund

Payment Mechanism for Purchase / Additional Purchase

Cheques accompanying the investment application are to be signed by the investor. Third-party cheques are not accepted. Third-party cheques are accepted in special cases. Payment by Parents/Grand-Parents/Related Persons on behalf of a minor in consideration of natural love and affection or as gift for a value not exceeding Rs 50,000/- for each regular Purchase or per SIP instalment. In such cases persons who make payment should be KYC Compliant and sign Third Party Declaration Form., Similarly, employer making payments on behalf of employee through payroll deductions, and custodian on behalf of FIIs are permitted third-party payments. RTGS is used for Instantaneous Transfer of Funds. In NEFT Fund is transferred in Batches. SWIFT is used for abroad transfer and takes 2 or 3 days.

Derivative Investments - Mutual Funds are barred from writing options (they can buy options) or purchasing instruments with embedded written options. In India, mutual fund AUM is hardly 10% of bank deposits.