Basics of mutual funds

HSBC
Asset Management

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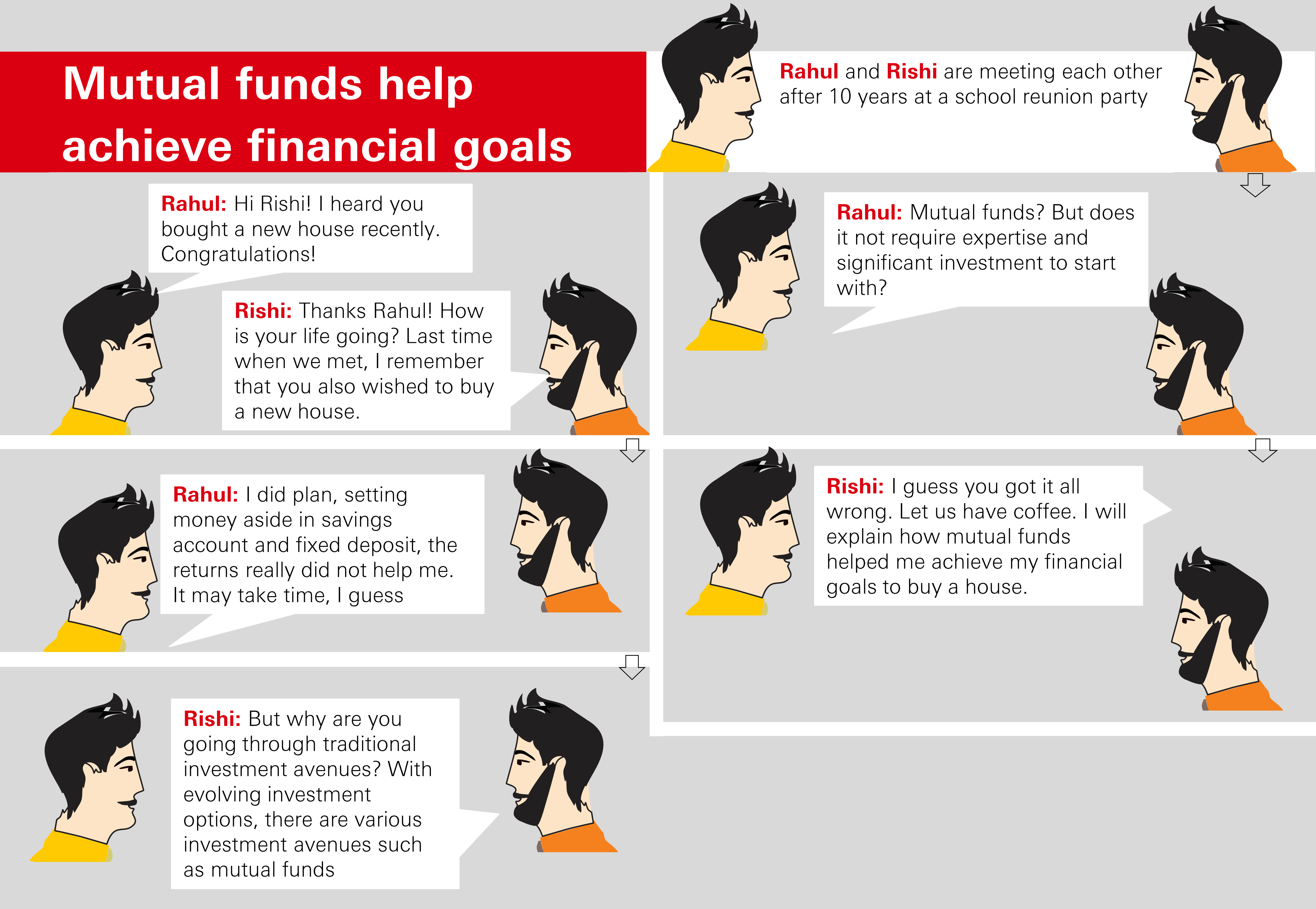
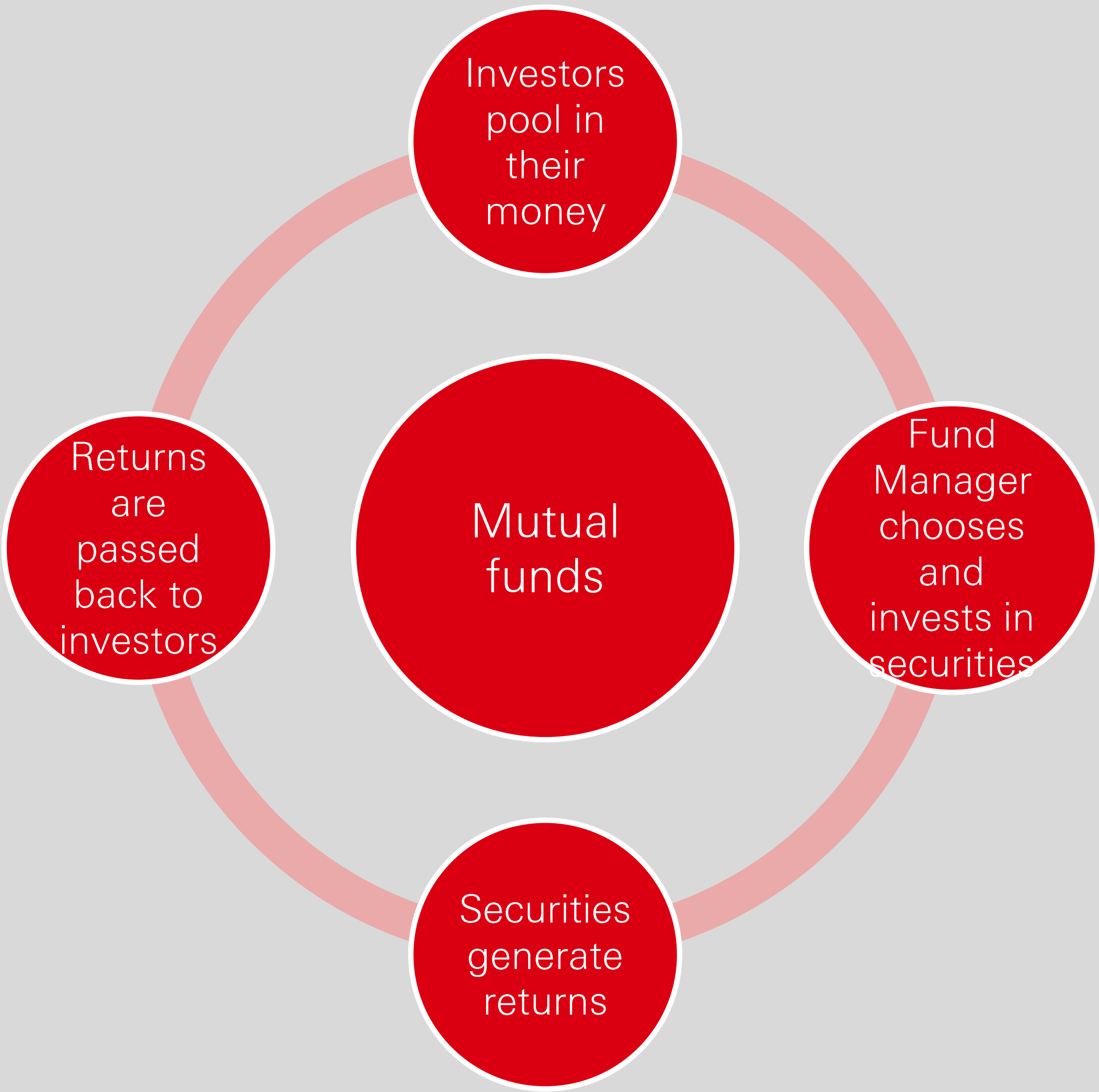
Mutual funds help achieve financial goals



Understanding mutual funds

Mutual funds collect money from a number of investors who share a common investment objective. It invests these in equities, bonds, money market instruments, and/or other securities.



Note - For illustration purpose only.

Types of mutual funds

- **Mutual funds**
  - **Equity**
    - Large cap, multi-cap, mid-cap, large and mid-cap, small cap
    - Divided yield, value, contra, focused, thematic/sectoral and ELSS
  - **Debt**
    - Low duration, ultra short duration, liquid, overnight, money market,
    - Medium duration and short duration
    - Medium-to-long duration
    - Long duration and gilt schemes
  - **Hybrid**
    - Aggressive hybrid, conservative hybrid, balance hybrid
    - Dynamic asset allocation / balanced advantage
    - Multi asset allocation, arbitrage fund, equity savings
  - **Solution-oriented schemes**
    - Retirement fund and children's fund
  - **Other schemes**
    - Index funds/ ETFs and fund of funds (FoFs)

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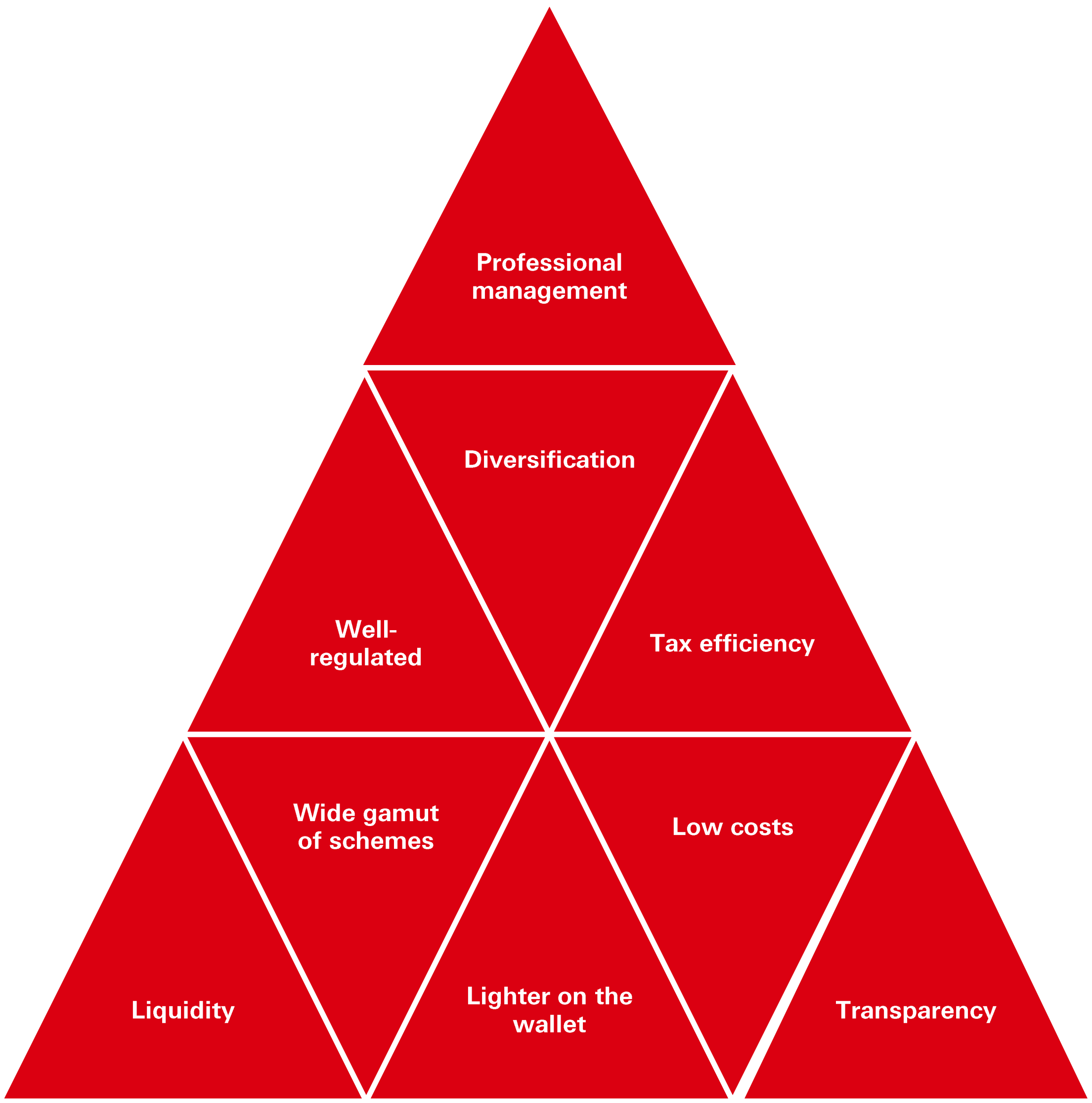
Benefits of investing in mutual funds

Mutual funds are slowly emerging as wealth creation tools due to its wide-ranging benefits such as:



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Meet investor goals based on risk profile

- Investors should identify and understand their risk profiles to take stock of their financial situation.
- The willingness and capability to take risks would determine investment decisions.
- Young investors, for instance, can build an aggressive portfolio with higher equity allocation owing to their higher risk appetite and an adequately long investment horizon (10 years and beyond).
- Factors to be considered by investors while identifying their risk profiles include their earning power, family commitments, financial goals, and age

Very conservative	• Typically, these investors are conservative and their top priority is safeguarding their capital. They are willing to accept relatively low returns against a low risk of principal
Conservative	• These investors are moderately conservative and are willing to accept a small level of risk in exchange of returns
Moderate	• These investors are ready to accept a moderate level of risk for relatively high returns over the medium to long term
Aggressive	• These investors are moderately aggressive and can tolerate a relatively high risk to expand potential returns over the medium-to-long term
Very aggressive	• These investors are aggressive and ready to accept a significant risk to maximise potential returns over the long term

Note - For illustration purpose only.

Case study

Rahul and Rishi had a common goal to buy a house and start investing for the same over a 10-year period. While Rishi opted for investment in equity fund through SIP, Rahul invested in fixed deposits.

Year	Monthly investment amount (Rs)	Total SIP value in the year (Rs)	Total FD value in the year (Rs)
1	10000	1.28 lakh	1.24 lakh
2	10000	2.75 lakh	2.57 lakh
3	10000	4.44 lakh	4.00 lakh
4	10000	6.39 lakh	5.54 lakh
5	10000	8.63 lakh	7.19 lakh
6	10000	11.20 lakh	8.97 lakh
7	10000	14.17 lakh	10.87 lakh
8	10000	17.57 lakh	12.92 lakh
9	10000	21.49 lakh	15.13 lakh
10	10000	26.00 lakh	17.50 lakh
Total		**1.13 crore**	**85.97 lakh**

Rishi enjoyed returns of about 15%* by investing in equity funds over 10 years, while Rahul's overall corpus was comparatively lower as investment in fixed deposit could return about 7.4%^.

Note: Calculation based on a SIP growth rate of 15%, which is the 15-year daily rolling average returns of the S&P BSE Sensex since 1979 till December 2021, ~ Approximation to the nearest thousand

* Performance based on weighted average index based on CRISIL ranked large cap funds

^ Fixed income fund return - Represented by three-year CAGR return of weighted average index of CRISIL ranked short duration funds category and bank FD return represented by returns are as per three-year CRISIL FD index

Mutual funds can help meet investment goals

As discussed earlier, investors can diversify their investments under various categories of mutual funds to meet their financial goals. They can chose mutual fund schemes in accordance with their risk appetite and financial stability to reach their investment goals

Goal type	Mutual fund type	Rationale
Long term, such as retirement, and children's higher education and wedding	Equity mutual funds and solution-oriented funds	Equity as an asset class has the potential of being a wealth creator Similarly, in solution-oriented funds, investors can customise their portfolios based on their risk appetite and investment goals
Medium term, such as purchase of house and vacation	Hybrid mutual funds	Hybrid mutual funds are a mix of equity and debt generally with a medium-term horizon. These funds vary based on the equity and debt ratio
Short term, such as car purchase, children's education and exigencies	Money market and debt mutual funds	Short-term tenures are based on three main parameters: liquidity, relative stability, and returns. Debt funds are mark-to-market products, subject to certain risks, such as credit and interest rate risks

Note - For illustration purpose only.

Use SIP, STP, and SWP as part of a disciplined investment approach

Systematic investment plan (SIP), systematic transfer plan (STP), and systematic withdrawal plan (SWP) offer disciplined investment routes to meet financial goals

SIP

- Investors contribute a fixed sum at regular intervals
- It is useful for investors to meet their goals across life stages and also avert equity market volatility by investing via SIP in equity mutual funds

STP

- It allows investors to systematically transfer a fixed amount from one scheme to another at regular intervals
- It can be effectively used as a tool to mitigate risks by systematically changing asset allocation by transferring from one asset class to another (which will be debt-to-equity and vice versa)

SWP

- Investors can withdraw/redeem money from a mutual fund scheme at pre-determined intervals. This is a reverse of SIP
- Investors can opt for weekly, monthly, quarterly, half-yearly or yearly withdrawals according to their cash flow requirement
- Based on investors' financial goals, an equivalent sum is redeemed from the scheme (subject to applicable loads and taxes)

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Simplifying mutual fund jargons

Of late, due to increased awareness, retail investors have started showing interest in investing in mutual funds. However, financial jargons used while speaking about a mutual fund schemes, compel many investors to procrastinate their investment decisions.

Here, let us understand few financial jargons that would provide more clarity about mutual fund schemes

- **Net asset value or NAV:** It is the most commonly associated word with mutual funds and widely used by investors while buying and selling mutual fund units. In simple words, NAV is the value of each unit of a particular mutual fund scheme on any given business day. It varies on a daily basis as the market value of securities change every day. NAV helps determine the price at which an investor can purchase or sell mutual fund units
- **Benchmark Index:** Another phrase we often we hear that 'a particular scheme has outperformed or underperformed its benchmark index'. This index is picked up by the fund house and can serve as a standard for the scheme's returns. Benchmark indices are closely connected to the nature of the scheme. For instance, an equity scheme may have benchmark indices such as S&P BSE Sensex and CNX Nifty. It enables investors compare the scheme's performance with that of the wider market
- **Compounded Annualized Growth Rate (CAGR):** It is the return of a fund from one point to the other after factoring in the time for holding investments. It indicates the value of investment during its tenure
- **Asset allocation:** It is an investment strategy that aims to spread investor's portfolio across several assets such as equities, bonds, gold and cash according to their age, goals, risk tolerance ability, and investment horizon

Simplifying mutual fund jargons

- **Average maturity:** Pure debt and hybrid mutual funds have different types of fixed income instruments in their portfolio, with each having a maturity date. Average maturity refers to the average of the maturities of the entire debt instrument in the portfolio of the fund
- **Credit quality:** While investing in debt funds investors should gauge the credit quality of the instruments in the portfolio. The instruments' credit rating indicates the level of default risk
- **Indexation benefit:** It is an option available for investors to manage their inflation adjusted returns. It is a provision in the Indian Income Tax Act, which allows investors to use inflation as a tool to reduce their tax liability from income generated through debt mutual funds and bonds
- **Standard Deviation:** It implies how much returns on a fund are deviating from average returns based on its historical performance. Standard deviation identifies the degree to which the fund fluctuates in relation to the average returns of a fund over a period of time
- **Beta:** It measures the volatility of a particular fund compared with the market as a whole. It will indicate how sensitive the fund's returns are to the fluctuation in the market
- **Jensen's Alpha**: The excess or abnormal returns earned by the mutual fund portfolio compared to its benchmark. A positive alpha on the investment implies that the fund has performed better than expected, given its beta. A negative alpha indicates that the fund has underperformed
- **Sharpe Ratio:** This ratio measures the risk-adjusted performance for each unit of dispersion measured by standard deviation.
- **Treynor Ratio:** As a variant of the Sharpe Ratio, this ratio measures the risk-adjusted performance for each unit of dispersion measured by beta (i.e. market risk). This ratio is similar to the Sharpe Ratio, but uses beta as the volatility measurement
- **R-squared:** This term is used to gauge the correlation between the mutual fund scheme and the benchmark index measured in the range of 0-100

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