

There are a lot of investment avenues available today in the financial market for an investor with an investable surplus. He can invest in Bank Deposits, Corporate Debentures, and Bonds where there is low risk but low return. He may invest in Stock of companies where the risk is high and the returns are also proportionately high. The recent trends in the Stock Market have shown that an average retail investor always lost with periodic bearish trends. People began opting for portfolio managers with expert ise in stock markets who would invest on their behalf. Thus we had wealth management services provided by many institutions. However they proved too costly for a small investor. These investors have found a good shelter with the mutual funds.

Mutual fund industry has seen a lot of changes in past few years with multinational companies coming into the country, bringing in their professional expertise in managing funds worldwide. In the past few months there has been a consolidation phase going on in the mutual fund industry in India. Now investors have a wide range of Schemes to choose from depending on their individual profiles.

My study gives an overview of mutual funds – definition, types, benefits, risks, limitations, history of mutual funds in India, latest trends, global scenarios. I have analyzed a few prominent mutual funds schemes and have given my findings.

#### NEED FOR THE STUDY

The main purpose of doing this project was to know about mutual fund and its functioning. This helps to know in details about mutual fund industry right from its inception stage, growth and future prospects.

It also helps in understanding different schemes of mutual funds. Because my study depends upon prominent funds in India and their schemes like equity, income, balance as well as the returns associated with those schemes.

The project study was done to ascertain the asset allocation, entry load, exit load, associated with the mutual funds. Ultimately this would help in understanding the benefits of mutual funds to investors.

#### SCOPE OF THE STUDY

In my project the scope is limited to some prominent mutual funds in the mutual fund industry. I analyzed the funds depending on their schemes like equity, income, balance. But there is so many other schemes in mutual fund industry like specialized (banking, infrastructure, pharmacy) funds, index funds etc.

My study is mainly concentrated on equity schemes, the returns, in income schemes the rating of CRISIL, ICRA and other credit rating agencies.

#### OBJECTIVE

- To give a brief idea about the benefits available from Mutual Fund investment
- To give an idea of the types of schemes available.
- To discuss about the market trends of Mutual Fund investment.
- To study some of the mutual fund schemes and analyse them
- Observe the fund management process of mutual funds
- Explore the recent developments in the mutual funds in India
- To give an idea about the regulations of mutual funds

## METHODOLOGY

To achieve the objective of studying the stock market data has been collected.

Research methodology carried for this study can be two types

1. Primary
2. Secondary

### PRIMARY:

The data, which has being collected for the first time and it is the original data.

In this project the primary data has been taken from HSE staff and guide of the project.

### SECONDARY:

The secondary information is mostly taken from websites, books, journals, etc.

### Limitations

- The time constraint was one of the major problems.
- The study is limited to the different schemes available under the mutual funds selected.
- The study is limited to selected mutual fund schemes.
- The lack of information sources for the analysis part.

## INDUSTRY PROFILE

### BOMBAY STOCK EXCHANGES:

This stock exchange, Mumbai, popularly known as "BSE" was established in 1875 as "The Native share and stock brokers association", as a voluntary non- profit making association. It has an evolved over the years into its present status as the premiere stock exchange in the country. It may be noted that the stock exchanges the oldest one in Asia, even older than the Tokyo Stock Exchange, which was founded in 1878. The exchange, while providing an efficient and transparent market for trading in securities, upholds the interests of the investors and ensures redressed of their grievances, whether against the companies or its own member brokers. It also strives to educate and enlighten the investors by making available necessary informative inputs and conducting investor education programmes.

A governing board comprising of 9 elected directors, 2 SEBI nominees, 7 public representatives and an executive director is the apex body, which decides the policies and regulates the affairs of the exchange.

The Executive director as the chief executive officer is responsible for the day today administration of the exchange. The average daily turnover of the exchange during the year 2000-01(April-March) was Rs 3984.19 crores and average number of daily trades 5.69 Lakhs.

However the average daily turn over of the exchange during the year 2001-02 has declined to Rs. 1244.10 crores and number of average daily trades during the period to 5.17 Lakhs.

The average daily turn over of the exchange during the year 2002-03 has declined and number of average daily trades during the period is also decreased.

The Ban on all deferral products like BLESS AND ALBM in the Indian capital markets by SEBI with effect from July 2, 2001, abolition of account period settlements, introduction of compulsory rolling settlements in all scripts traded on the exchanges with effect from Dec 31, 2001, etc., have adversely impacted the liquidity and consequently there is a considerable decline in the daily turn over at the exchange. The average daily turn over of the exchange present scenario is 110363 (lacs) and number of average daily trades 1057 (lacs).

#### BSE INDICES:

In order to enable the market participants, analysts etc., to track the various ups and downs in the Indian stock market, the Exchange has introduced in 1986 an equity stock index called BSE-SENSEX that subsequently became the barometer of the moments of the share prices in the Indian Stock market. It is a "Market capitalization weighted" index of 30 component stocks representing a sample of large, well-established and leading companies. The base year of Sensex is 1978-79. The Sensex is widely reported in both domestic and international markets through print as well as electronic media. Sensex is calculated using a market capitalization weighted method. As per this methodology, the level of the index reflects the total market value of all 30-component stocks from different industries related to particular base period. The total market value of a company is determined by multiplying the price of its stock by the number of shares outstanding. Statisticians call an index of a set of combined variables (such as price and number of shares) a composite Index. An Indexed number is used to represent the results of this calculation in order to make the value easier to work with and track over a time. It is much easier to graph a chart based on Indexed values than one based on actual values world over majority of the well-known Indices are constructed using "Market capitalization weighted method".

In practice, the daily calculation of SENSEX is done by dividing the aggregate market value of the 30 companies in the Index by a number called the Index Divisor. The Divisor is the only link to the original base period value of the SENSEX. The Divisor keeps the Index comparable over a period or time and if the reference point for the entire Index maintenance adjustments. SENSEX is widely used to describe the mood in the Indian Stock markets. Base year average is changed as per the formula new base year average = old base year average \* (new market value / old market value).

#### NATIONAL STOCK EXCHANGE:

The NSE was incorporated in Nov 1992 with an equity capital of Rs 25 crores. The International securities consultancy (ISC) of Hong Kong has helped in setting up NSE. ISE has prepared the detailed business plans and installation of hardware and software systems. The promoters for NSE were financial institutions, insurance companies, banks and SEBI capital market Ltd, Infrastructure leasing and financial services Ltd and stock holding corporation Ltd.

It has been set up to strengthen the move towards professionalisation of the capital market as well as provide nation wide securities trading facilities to investors. NSE is not an exchange in the traditional sense where brokers own and manage the exchange. A two tier administrative set up involving a company board and a governing board of the exchange is envisaged.

NSE is a national market for shares PSU bonds, debentures and government securities

since infrastructure and trading facilities are provided.

#### NSE-NIFTY:

The NSE on April 22, 1996 launched a new equity Index. The NSE -50. The new index, which replaces the existing NSE-100 index, is expected to serve as an appropriate Index for the new segment of futures and options.

“Nifty” means National Index for Fifty Stocks.

The NSE-50 comprises 50 companies that represent 20 broad Industry groups with an aggregate market capitalization of around Rs. 1,70,000 crs. All companies included in the Index have a market capitalization in excess of Rs 500 crs each and should have traded for 85% of trading days at an impact cost of less than 1.5%.

The base period for the index is the close of prices on Nov 3, 1995, which makes one year of completion of operation of NSE’s capital market segment. The base value of the Index has been set at 1000.

#### NSE-MIDCAP INDEX:

The NSE midcap Index or the Junior Nifty comprises 50 stocks that represents 21 aboard Industry groups and will provide proper representation of the midcap segment of the Indian capital Market. All stocks in the index should have market capitalization of greater than Rs.200 crores and should have traded 85% of the trading days at an impact cost of less 2.5%.

The base period for the index is Nov 4, 1996, which signifies two years for completion of operations of the capital market segment of the operations. The base value of the Index has been set at 1000.

Average daily turn over of the present scenario 258212 (Lacs) and number of averages daily trades 2160(Lacs).

At present, there are 24 stock exchanges recognized under the securities contract (regulation) Act, 1956. They are

#### NAMES OF THE STOCK EXCHANGES

Bombay stock exchange,  
Ahmedabad share and stock brokers association,  
Calcutta stock exchange association Ltd,  
Delhi stock exchange association Ltd,  
Madras stock exchange association Ltd,  
Indore stock brokers association Ltd,  
Banglore stock exchange,  
Hyderabad stock exchange,  
Cochin stock exchange,  
Pune stock exchange,  
U.P.stock exchange,  
Ludhiana stock exchange,  
Jaipur stock exchange Ltd,  
Gauhati stock exchange Ltd,  
Manglore stock exchange,  
Maghad stock exchange Ltd, Patna,  
Bhuvaneshwar stock exchange association Ltd,  
Over the counter exchange of India, Bombay,  
Saurashtra kuth stock exchange Ltd,

Vsdodard stock exchange Ltd,  
Coimbatore stock exchange Ltd,  
The Meerut stock exchange,  
National stock exchange,  
Integrated stock exchange

## THE HYDERABAD STOCK EXCHANGE LIMITED

### ORIGIN:

Rapid growth in industries in the erstwhile Hyderabad State saw efforts at starting the Stock Exchange. In November, 1941 some leading bankers and brokers formed the share and stock Brokers Association. In 1942, Mr. Gulab Mohammed, the Finance Minister formed a Committee for the purpose of constituting Rules and Regulations of the Stock Exchange. Sri Purushothamdas Thakurdas, President and Founder Member of the Hyderabad Stock Exchange performed the opening ceremony of the Exchange on 14.11.1943 under Hyderabad Companies Act, Mr. Kamal Yar Jung Bahadur was the first President of the Exchange. The HSE started functioning under Hyderabad Securities Contract Act of No. 21 of 1352 under H.E.H. Nizam's Government as a Company Limited by guarantee. It was the 6th Stock Exchange recognized under Securities Contract Act, after the Premier Stock Exchanges, Ahmedabad, Bombay, Calcutta, Madras and Bangalore stock Exchange. All deliveries were completed every Monday or the next working day.

The Securities Contracts (Regulation) Act 1956 was enacted by the Parliament, passed into Law and the rules were also framed in 1957. The Government of India brought the Act and the Rules into force from 20th February 1957.

The HSE was first recognized by the Government of India on 29th September 1958, as Securities Regulation Act was made applicable to twin cities of Hyderabad and Secunderabad from that date. In view of substantial growth in trading activities, and for the yeoman services rendered by the Exchange, the Exchange was bestowed with permanent recognition with effect from 29th September 1983.

The Exchange has a significant share in achievements of erstwhile State of Andhra Pradesh to its present state in the matter of Industrial development.

### OBJECTIVES:

The Exchange was established on 18th October 1943 with the main objective to create, protect and develop a healthy Capital Market in the State of Andhra Pradesh to effectively serve the Public and Investor's interests.

The property, capital and income of the Exchange, as per the Memorandum and Articles of Association of the Exchange, shall have to be applied solely towards the promotion of the objects of the Exchange. Even in case of dissolution, the surplus funds shall have to be devoted to any activity having the same objects, as Exchange or be distributed in Charity, as may be determined by the Exchange or the High Court of judicature. Thus, in short, it is a Charitable Institution.

The Hyderabad Stock Exchange Limited is now on its stride of completing its 65th year in the history of Capital 'Markets' serving the cause of saving and investments. The Exchange has made its beginning in 1943 and today occupies a prominent place among the Regional Stock Exchanges in India. The Hyderabad Stock Exchange has been promoting the mobilization of funds into the Industrial sector for development of industrialization in the State of Andhra Pradesh.

#### GROWTH:

The Hyderabad Stock Exchange Ltd., established in 1943 as a Non-profit making organization, catering to the needs of investing population started its operations in a small way in a rented building in Koti area. It had shifted into Aiyangar Plaza, Bank Street in 1987. In September 1989, the then Vice-President of India, Hon'ble Dr. Shankar Dayal Sharma had inaugurated the own building of the Stock exchange at Himayathnagar, Hyderabad. Later in order to bring all the trading members under one roof, the exchange acquired still a larger premises situated 6-3-654/A; Somajiguda, Hyderabad - 82, with a six storied building and a constructed area of about 4,86,842 sft (including cellar of 70,857 sft). Considerably, there has been a tremendous perceptible growth which could be observed from the statistics.

The number of members of the Exchange was 55 in 1943, 117 in 1993 and increased to 300 with 869 listed companies having paid up capital of Rs.19128.95 crores as on 31/03/2000. The business turnover has also substantially increased to Rs. 1236.51 crores in 1999-2000. The Exchange has got a very smooth settlement system.

#### GOVERNING BOARD

At present, the Governing Board consists of the following:

##### MEMBERS OF THE EXCHANGE:

Sri PANDURANGA REDDY K

Sri HARI KISHAN ATTAL

##### SEBI NOMINEE DIRECTORS:

Sri. HENRY RICHARD -- Registrar of Companies [Govt. of India.]

##### PUBLIC NOMINEE DIRECTORS:

Dr. N.R. Sivaswamy (Chairman, HSE) -- Former CBDT Chairman

Justice V. Bhaskara Rao -- Retd. Judge High Court

Sri P. Muralimohan Rao -- Mogili&Co.-Chartered Accountants

Dr B. Brahmaiah -- G.M.

##### COMPANY SECRETARY

Sri G SOMESWARA RAO,

#### COMPUTERIZATION:

The Stock Exchange business operations are equipped with modern communication systems. Online computerization for simultaneously carrying out the trading transactions, monitoring functions have been introduced at this Exchange since 1988 and the Settlement and Delivery System has become simple and easy to the Exchange members.

The HSE On-line Securities Trading System was built around the most sophisticated state of the art computers, communication systems, and the proven VECTOR Software from CMC and was one of the most powerful SBT Systems in the country, operating in a WAN environment, connected through 9.6 KBPS 2 wire Leased Lines from the offices of the members to the office of the Stock Exchange at Somajiguda, where the Central System CHALLENGE-L DESK SIDE SERVER made of Silicon Graphics (SGI Model No. D-95602-S2) was located and connected all the members who were provided with COMPAQ DESKPRO 2000/DESKTOP 5120 Computers connected through MOTOROLA 3265 v. 34 MANAGEABLE STAND ALONE MODEMS (28.8 kbps) for carrying out business from computer terminals located in the offices of the members. The HOST System enabled the

Exchange to expand its operations later to other prime trading centers outside the twin cities of Hyderabad and Secunderabad.

#### CLEARING HOUSE:

The Exchange set-up a Clearing House to collect the Securities from all the Members and distribute to each member, all the securities due in respect of every settlement. The whole of the operations of the Clearing House were also computerized. At present through DP all the settlement obligations are met.

#### INTER – CONNECTED MARKET SYSTEM (ICMS):

The HSE was the convener of a Committee constituted by the Federation of Indian Stock Exchanges for implementing an Inter-connected Market System(ICMS) in which the Screen Based Trading systems of various Stock Exchanges was inter-connected to create a large National Market. SEBI welcomed the creation of ICMS.

The HOST provided the network for HSE to hook itself into the ISE. The ISE provided the members of HSE and their investors, access to a large national network of Stock Exchanges.

The Inter-connected Stock Exchange is a National Exchange and all HSE Members could have trading terminals with access to the National Market without any fee, which was a boon to the Members of an Exchange/Exchanges to have the trading rights on National Exchange (ISE), without any fee or expenditure.

#### ON-LINE SURVEILLANCE:

HSE pays special attention to Market Surveillance and monitoring exposures of the members, particularly the mark to market losses. By taking prompt steps to collect the margins for mark to market losses, the risk of default by members is avoided. It is heartening that there have been no defaults by members in any settlement since the introduction of Screen Based Trading.

#### IMPROVEMENT IN THE VOLUMES:

It is heartening that after implementing HOST, HSE's daily turnover has fairly stabilized at a level of Rs. 20.00 crores. this should enable in improving our ranking among Indian Stock Exchanges for 14th position to 6th position. We shall continuously strive to improve upon this to ensure a premier position for our Exchange and its members and to render excellent services to investors in this region.

#### SETTLEMENT GUARANTEE FUND:

The Exchange has introduced Trade Guarantee Fund on 25/01/2000. This will insulate the trading member from the counter-party risks while trading with another member. In other words, the trading member and his investors will be assured of the timely completion of the pay-out of funds and securities notwithstanding the default, if any, of any trading member of the Exchange. The shortfalls, if any, arising from the default of any member will be met out of the Trade Guarantee Fund. Several pay-ins worth of crores of rupees in all the settlements have been successfully completed after the introduction of Trade Guarantee Fund, without utilizing any amount from the Trade Guarantee Fund.

The Trade Guarantee Fund will be a major step in re-building this confidence of the members and the investors in HSE. HSE's Trade Guarantee Fund has a corpus of Rs.



2.00 crores initially which will later be raised to Rs. 5.00 crores. At present Rs. 3.20 Crores is stood in the credit of SGF.

The Trade Guarantee Fund had strict rules and regulations to be complied with by the members to avail the guarantee facility. The HOST system facilitated monitoring the compliance of members in respect of such rules and regulations.

#### CURRENT DIVERSIFICATIONS:

##### A) DEPOSITORY PARTICIPANT:

The Exchange has also become a Depository Participant with National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL). Our own DP is fully operational and the execution time will come down substantially. The depository functions are undertaken by the Exchange by opening the accounts at Hyderabad of investors, members of the Exchange and other Exchanges. The trades of all the Exchanges having On-line trading which get into National depository can also be settled at Hyderabad by this exchange itself. In short all the trades of all the investors and members of any Exchange at Hyderabad in dematerialized securities can be settled by the Exchange itself as a participant of NSDL and CDSL. The exchange has about 15,000 B.O. accounts.

##### B) FLOATING OF A SUBSIDIARY COMPANY FOR THE MEMBERSHIP OF MAJOR STOCK EXCHANGES OF the COUNTRY:

The Exchange had floated a Subsidiary Company in the name and style of M/s HSE Securities Limited for obtaining the Membership of NSE and BSE. The Subsidiary had obtained membership of both NSE and BSE. About 113 Sub-brokers may registered with HSES, of which about 75 sub-brokers are active. Turnover details are furnished here under.

#### History of mutual funds

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Government of India and Reserve Bank of India. The history of mutual funds in India can be broadly divided into four distinct phases.

First Phase – 1964-87: Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

Second Phase – 1987-1993 (Entry of Public Sector Funds): 1987 marked the entry of non- UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non- UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990.

At the end of 1993, the mutual fund industry had assets under management of Rs.47,004 crores.

Third Phase – 1993-2003 (Entry of Private Sector Funds): With the entry of private



sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996.

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

Fourth Phase – since February 2003: In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs.29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76,000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As at the end of September, 2004, there were 29 funds, which manage assets of Rs.153108 crores under 421 schemes.

## ADVANTAGES OF MUTUAL FUNDS

There are numerous benefits of investing in mutual funds and one of the key reasons for its phenomenal success in the developed markets like US and UK is the range of benefits they offer, which are unmatched by most other investment avenues. We have explained the key benefits in this section. The benefits have been broadly split into universal benefits, applicable to all schemes, and benefits applicable specifically to open-ended schemes. Universal Benefits

**Affordability:** A mutual fund invests in a portfolio of assets, i.e. bonds, shares, etc. depending upon the investment objective of the scheme. An investor can buy in to a portfolio of equities, which would otherwise be extremely expensive. Each unit holder thus gets an exposure to such portfolios with an investment as modest as Rs.500/-. This amount today would get you less than quarter of an Infosys share! Thus it would be affordable for an investor to build a portfolio of investments through a mutual fund rather than investing directly in the stock market. **Diversification** The nuclear weapon in your arsenal for your fight against Risk. It simply means that you must spread your investment across different securities (stocks, bonds, money market instruments, real estate, fixed deposits etc.) and different sectors (auto, textile, information technology

etc.). This kind of a diversification may add to the stability of your returns, for example during one period of time equities might under perform but bonds and money market instruments might do well enough to offset the effect of a slump in the equity markets. Similarly the information technology sector might be faring poorly but the auto and textile sectors might do well and may protect your principal investment as well as help you meet your return objectives. Variety Mutual funds offer a tremendous variety of schemes. This variety is beneficial in two ways: first, it offers different types of schemes to investors with different needs and risk appetites; secondly, it offers an opportunity to an investor to invest sums across a variety of schemes, both debt and equity. For example, an investor can invest his money in a Growth Fund (equity scheme) and Income Fund (debt scheme) depending on his risk appetite and thus create a balanced portfolio easily or simply just buy a Balanced Scheme.

**Professional Management:** Qualified investment professionals who seek to maximize returns and minimize risk monitor investor's money. When you buy in to a mutual fund, you are handing your money to an investment professional who has experience in making investment decisions. It is the Fund Manager's job to (a) find the best securities for the fund, given the fund's stated investment objectives; and (b) keep track of investments and changes in market conditions and adjust the mix of the portfolio, as and when required.

**Tax Benefits:** Any income distributed after March 31, 2002 will be subject to tax in the assessment of all Unit holders. However, as a measure of concession to Unit holders of open-ended equity-oriented funds, income distributions for the year ending March 31, 2003, will be taxed at a concessional rate of 10.5%.

In case of Individuals and Hindu Undivided Families a deduction upto Rs. 9,000 from the Total Income will be admissible in respect of income from investments specified in Section 80L, including income from Units of the Mutual Fund. Units of the schemes are not subject to Wealth-Tax and Gift-Tax.

**Regulations:** Securities Exchange Board of India ("SEBI"), the mutual funds regulator has clearly defined rules, which govern mutual funds. These rules relate to the formation, administration and management of mutual funds and also prescribe disclosure and accounting requirements. Such a high level of regulation seeks to protect the interest of investors

**Benefits of Open-ended Schemes:**

**Liquidity:** In open-ended mutual funds, you can redeem all or part of your units any time you wish. Some schemes do have a lock-in period where an investor cannot return the units until the completion of such a lock-in period.

**Convenience:** An investor can purchase or sell fund units directly from a fund, through a broker or a financial planner. The investor may opt for a Systematic Investment Plan ("SIP") or a Systematic Withdrawal Advantage Plan ("SWAP"). In addition to this an investor receives account statements and portfolios of the schemes.

**Flexibility:** Mutual Funds offering multiple schemes allow investors to switch easily between various schemes. This flexibility gives the investor a convenient way to change the mix of his portfolio over time.

**Transparency:** Open-ended mutual funds disclose their Net Asset Value ("NAV") daily and the entire portfolio monthly. This level of transparency, where the investor himself sees the underlying assets bought with his money, is unmatched by any other financial instrument. Thus the investor is in the know of the quality of the portfolio and can invest further or redeem depending on the kind of the portfolio that has been constructed by

the investment manager.

## RISK FACTORS OF MUTUAL FUNDS

The Risk-Return Trade-off:

The most important relationship to understand is the risk-return trade-off. Higher the risk greater the returns/loss and lower the risk lesser the returns/loss.

Hence it is upto you, the investor to decide how much risk you are willing to take. In order to do this you must first be aware of the different types of risks involved with your investment decision.

**Market Risk:** Sometimes prices and yields of all securities rise and fall. Broad outside influences affecting the market in general lead to this. This is true, may it be big corporations or smaller mid-sized companies. This is known as Market Risk. A Systematic Investment Plan ("SIP") that works on the concept of Rupee Cost Averaging ("RCA") might help mitigate this risk.

**Credit Risk:** The debt servicing ability (may it be interest payments or repayment of principal) of a company through its cashflows determines the Credit Risk faced by you. This credit risk is measured by independent rating agencies like CRISIL who rate companies and their paper. A 'AAA' rating is considered the safest whereas a 'D' rating is considered poor credit quality. A well-diversified portfolio might help mitigate this risk.

**Inflation Risk:** Things you hear people talk about:

"Rs. 100 today is worth more than Rs. 100 tomorrow."

"Remember the time when a bus ride costed 50 paise?"

"Mehangai Ka Jamana Hai."

The root cause, Inflation. Inflation is the loss of purchasing power over time. A lot of times people make conservative investment decisions to protect their capital but end up with a sum of money that can buy less than what the principal could at the time of the investment. This happens when inflation grows faster than the return on your investment. A well-diversified portfolio with some investment in equities might help mitigate this risk.

**Interest Rate Risk:** In a free market economy interest rates are difficult if not impossible to predict. Changes in interest rates affect the prices of bonds as well as equities. If interest rates rise the prices of bonds fall and vice versa. Equity might be negatively affected as well in a rising interest rate environment. A well-diversified portfolio might help mitigate this risk.

**Political/Government Policy Risk:** Changes in government policy and political decision can change the investment environment. They can create a favorable environment for investment or vice versa.

**Liquidity Risk:** Liquidity risk arises when it becomes difficult to sell the securities that one has purchased. Liquidity Risk can be partly mitigated by diversification, staggering of maturities as well as internal risk controls that lean towards purchase of liquid securities.

Various investment options in Mutual Funds offer

To cater to different investment needs, Mutual Funds offer various investment options.

Some of the important investment options include:

**Growth Option:**

Dividend is not paid-out under a Growth Option and the investor realises only the capital appreciation on the investment (by an increase in NAV).

**Dividend Payout Option:**

Dividends are paid-out to investors under the Dividend Payout Option. However, the NAV of the mutual fund scheme falls to the extent of the dividend payout.

**Dividend Re-investment Option:**

Here the dividend accrued on mutual funds is automatically re-invested in purchasing additional units in open-ended funds. In most cases mutual funds offer the investor an option of collecting dividends or re-investing the same.

**Retirement Pension Option:**

Some schemes are linked with retirement pension. Individuals participate in these options for themselves, and corporates participate for their employees.

**Insurance Option:**

Certain Mutual Funds offer schemes that provide insurance cover to investors as an added benefit.

**Systematic Investment Plan (SIP):**

Here the investor is given the option of preparing a pre-determined number of post-dated cheques in favour of the fund. The investor is allotted units on a predetermined date specified in the offer document at the applicable NAV.

**Systematic Withdrawal Plan (SWP):**

As opposed to the Systematic Investment Plan, the Systematic Withdrawal Plan allows the investor the facility to withdraw a pre-determined amount / units from his fund at a pre-determined interval. The investor's units will be redeemed at the applicable NAV as on that day.

**Future of Mutual Funds in India**

By December 2004, Indian mutual fund industry reached Rs 1,50,537 crore. It is estimated that by 2010 March-end, the total assets of all scheduled commercial banks should be Rs 40,90,000 crore.

The annual composite rate of growth is expected 13.4% during the rest of the decade. In the last 5 years we have seen annual growth rate of 9%. According to the current growth rate, by year 2010, mutual fund assets will be double.

## GROWTH OF MUTUAL FUNDS IN INDIA

The Indian Mutual Fund has passed through three phases. The first phase was between 1964 and 1987 and the only player was the Unit Trust of India, which had a total asset of Rs. 6,700 crores at the end of 1988. The second phase is between 1987 and 1993 during which period 8 Funds were established (6 by banks and one each by LIC and GIC). The total assets under management had grown to 61,028 crores at the end of 1994 and the number of schemes was 167.

The third phase began with the entry of private and foreign sectors in the Mutual Fund industry in 1993. Kothari Pioneer Mutual Fund was the first Fund to be established by the private sector in association with a foreign Fund.

As at the end of financial year 2000(31st march) 32 Funds were functioning with Rs. 1, 13,005 crores as total assets under management. As on august end 2000, there were 33 Funds with 391 schemes and assets under management with Rs 1, 02,849 crores.

The securities and Exchange Board of India (SEBI) came out with comprehensive regulation in 1993 which defined the structure of Mutual Fund and Asset Management Companies for the first time.

Several private sectors Mutual Funds were launched in 1993 and 1994. The share of the private players has risen rapidly since then.

Currently there are 34 Mutual Fund organizations in India managing 1,02,000 crores.

#### ANALYSIS OF MUTUAL FUNDS SCHEMES

To study the currently available schemes I have taken the fact sheets available with the AMCs. The fact sheet provides the historical data about the various schemes offered by the AMC, investment pattern, dividend history, ratings given, Fund Managers' Credentials, etc.

I have analyzed the schemes in the following three categories:

- Equity or Growth Scheme
- Balanced Scheme
- Income or Debt Scheme

I have studied the schemes of the following AMCs

- Kotak Mutual Fund
- SBI Mutual Fund
- Franklin Templeton India Mutual Fund
- Principal Mutual fund

#### Basis for Analysis

Net Asset Value (NAV) is the best parameter on which the performance of a mutual fund can be studied. We have studied the performance of the NAV based on the compounded annual return of the Scheme in terms of appreciation of NAV, dividend and bonus issues. WE have compared the Annual returns of various schemes to get an idea about their relative standings.

#### VALUATION OF MUTUAL FUND

The net asset value of the Fund is the cumulative market value of the assets Fund net of its liabilities. In other words, if the Fund is dissolved or liquidated, by selling off all the assets in the Fund, this is the amount that the shareholders would collectively own. This gives rise to the concept of net asset value per unit, which is the value, represented by the ownership of one unit in the Fund. It is calculated simply by dividing the net asset value of the Fund by the number of units. However, most people refer loosely to the NAV per unit as NAV, ignoring the "per unit". We also abide by the same convention.

#### Calculation of NAV

The most important part of the calculation is the valuation of the assets owned by the Fund. Once it is calculated, the NAV is simply the net value of assets divided by the number of units outstanding. The detailed methodology for the calculation of the net asset value is given below.

The net asset value is the actual value of a unit on any business day. NAV is the

barometer of the performance of the scheme.

The net asset value is the market value of the assets of the scheme minus its liabilities and expenses. The per unit NAV is the net asset value of the scheme divided by the number of the units outstanding on the valuation date.

#### Equity or Growth Scheme

These schemes, also commonly called Growth Schemes, seek to invest a majority of their funds in equities and a small portion in money market instruments. Such schemes have the potential to deliver superior returns over the long term. However, because they invest in equities, these schemes are exposed to fluctuations in value especially in the short term.

In this equity or growth scheme segment I selected the following schemes in the selected AMC's

#### Balanced Scheme

The aim of Balanced Funds is to provide both growth and regular income. Such schemes periodically distribute a part of their earning and invest both in equities and fixed income securities in the proportion indicated in their offer documents. This proportion affects the risks and the returns associated with the balanced fund - in case equities are allocated a higher proportion, investors would be exposed to risks similar to that of the equity market.

Balanced funds with equal allocation to equities and fixed income securities are ideal for investors looking for a combination of income and moderate growth.

In this balanced fund scheme segment I selected the following schemes in the selected AMC's

SBI Magnum Balance Fund has not been given any rating by CRISIL but it has been performing well. The investments of the Funds are well diversified in both Equity and Debt. The total Equity Holdings as on April 30th stands at 67.77% of the total assets. It has out performed CRISIL Balanced Fund Index by 45.38% for the 52 weeks period.

Principal Balanced Fund has ranked CP3 by CRISAL, which means average in the open-ended balanced Fund category and ranks within the top 70% of the 19 schemes in this category. It has invested 67% in Equity and about 16% in Government Securities. In Equity it invested primarily in Pharmaceuticals, Construction Materials, Automobiles and banks.

Franklin Templeton India Balanced Fund invested about 70% of its assets in Equity and 75% in Debts. The recent additions to its portfolio are Reliance Industries, Asian paints and BPCL. It invests primarily in IT consulting, auto parts equipment, Banks, Tele Electrical industrial conglomerates. It invested mainly in the AAA rated Debts.

Kotak Balance Fund has invested close to 70% in Equity and about 30% in Debt instruments and Short Term Deposits. The Fund has a well-diversified portfolio of equity with prime investments in BHEL, Siemens EID parry, Bulrampur Chini and SBI. In the debt Instruments it has invested in Railway Bonds and 2003 maturing Government Stock.

SBI Magnum Income Fund is performing very well right from the inception with generous

payment of dividends has been assigned AAA rating by CRISIL. The Fund invests about 90% in AAA rated securities and more than 60% of its investments have a maturity ranging between 3 to 10 years. It has come with bonuses in Jan 2003 1:3 and September 2003 1:10. However, it under performs vis-à-vis CRISIL Comp. Bond Fund index by 0.14.

Principal Income Fund has ranked CP3 by CRISAL, which means average in the open-ended debt category and ranks within the top 70% of the 21 schemes in this category. The investments have average maturity of 7.3 years with more than 50% investments having a maturity of above 7 years. It has invested close to 50% in Government Securities, above 40% in NCD/Deep Discount Bonds.

Franklin Templeton India Income Fund has most of the investments in low risk AAA and sovereign securities. Above 45% of the investments are in Gilt, 25% in PSU/PFI bonds and 24% in corporate Debts. The average maturity of this scheme is at 4.87 years. The performance of the Fund is inline with CRISIL Composite Bond Fund.

Kotak Liquid Fund has invested about close to 25% in corporate Debt, 10% in public sector undertakings, about 25% in money market instruments. It has also invested 40% in term deposits. The average maturity of portfolio is 2.3 years. Almost all the instruments are well rated implying they are safe instruments also their investments are highly diversified.

## SUGGESTIONS

Four sequential steps will enable investor to decide effectively.

1. Divide the spectrum of Mutual Funds depending on major asset classes invested in. Presently there are only two.

- Equity Funds investing in stocks.
- Debt Funds investing in interest paying securities issued by government, semi-government bodies, public sector units and corporates.

2. a) Categorizing equities

- Diversified – invest in large capitalized stocks belonging to multiple sectors.
- Sectorial – Invest in specific sectors like technology, FMCG, Pharma, etc.

b) Categorized Debt.

- Gilt – Invest only in government securities, long maturity securities with average of 9 to 13 years, very sensitive to interest rate movement.
- Medium Term Debt (Income Funds) – Invest in corporate debt, government securities and PSU bonds. Average maturity is 5 to 7 years.
- Short Term Debt – Average maturity is 1 year. Interest rate sensitivity is very low with steady returns.
- Liquid – Invest in money market, other short term paper, and cash. Highly liquid. Average maturity is three months.

3. Review Categories

- Diversified equity has done very well while sectorial categories have fared poorly in Indian market.
- Index Funds have delivered much less compared to actively managed Funds.
- Gilt and Income Funds have performed very well during the last three years. They perform best in a falling interest environment. Since interest rates are now much lower, short term Funds are preferable.



#### 4. Specific scheme selection

Rankings are based on criteria including past performance, risk and resilience in unfavorable conditions, stability and investment style of Fund management, cost and service levels. Some recommended schemes are:

- Diversified equity – Zurich Equity, Franklin India Bluechip, Sundaram Growth. These Funds show good resilience giving positive results.
- Gilt Funds – DSP Merrill Lynch, Tata GSF, HDFC Gilt have done well.
- Income Fund – HDFC, Alliance, Escorts and Zurich are top performers
- Short Term Funds – Pru ICICI, Franklin Templeton are recommended

Within debt class, presently more is allocated towards short term Funds, because of low prevailing interest rates.

However if interest rates go up investor can allocate more to income Funds or gilt Funds.

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#### An Introduction to Mutual Funds

Over the past decade, American investors increasingly have turned to mutual funds to save for retirement and other financial goals. Mutual funds can offer the advantages of diversification and professional management. But, as with other investment choices, investing in mutual funds involves risk. And fees and taxes will diminish a fund's returns. It pays to understand both the upsides and the downsides of mutual fund investing and how to choose products that match your

goals and tolerance for risk.

This brochure explains the basics of mutual fund investing — how mutual funds work, what factors to consider before investing, and how to avoid common pitfalls.

#### Key Points to Remember

Mutual funds are not guaranteed or insured by the FDIC or any other government agency— even if you buy through a bank and the fund carries the bank's name. You can lose money investing in mutual funds.

Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns. But past performance can help you assess a fund's volatility over time.

All mutual funds have costs that lower your investment returns. Shop around, and use a mutual fund cost calculator at [www.sec.gov/investor/tools.shtml](http://www.sec.gov/investor/tools.shtml) to compare many of the costs of owning different funds before you buy.

#### How Mutual Funds Work

##### What They Are

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate.

#### Other Types of Investment Companies

Legally known as an "open-end company," a mutual fund is one of three basic types of investment companies. While this brochure discusses only mutual funds, you should be aware that other pooled investment vehicles exist and may offer features that you desire. The two other basic types of investment companies are:

Closed-end funds — which, unlike mutual funds, sell a fixed number of shares at one time (in an initial public offering) that later trade on a secondary market; and

Unit Investment Trusts (UITs) — which make a one-time public offering of only a specific, fixed number of redeemable securities called "units" and which will terminate and dissolve on a date specified at the creation of the UIT.

"Exchange-traded funds" (ETFs) are a type of investment company that aims to achieve the same return as a particular market index. They can be either open-end companies or UITs. But ETFs are not considered to be, and are not permitted to call themselves, mutual funds.

Some of the traditional, distinguishing characteristics of mutual funds include the following:

Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market.

The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads).

Mutual fund shares are "redeemable," meaning investors can sell their shares back to the fund (or to a broker acting for the fund).

Mutual funds generally create and sell new shares to accommodate new investors. In other words, they sell their shares on a continuous basis, although some funds stop selling when, for example, they become too large.

The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisers" that are registered with the SEC.

#### A Word About Hedge Funds and "Funds of Hedge Funds"

"Hedge fund" is a general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are not mutual funds and, as such, are not subject to the numerous regulations that apply to mutual funds for the protection of investors — including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more.

"Funds of hedge funds," a relatively new type of investment product, are investment companies that invest in hedge funds. Some, but not all, register with the SEC and file semi-annual reports. They often have lower minimum investment thresholds than traditional, unregistered hedge funds and can sell their shares to a larger number of investors. Like hedge funds, funds of hedge funds are not mutual funds. Unlike open-end mutual funds, funds of hedge funds offer very limited rights of redemption. And, unlike ETFs, their shares are not typically listed on an exchange.

You'll find more information about hedge funds on our website. To learn more about funds of hedge funds, please read NASD's Investor Alert entitled Funds of Hedge Funds: Higher Costs and Risks for Higher Potential Returns.

## Advantages and Disadvantages

Every investment has advantages and disadvantages. But it's important to remember that features that matter to one investor may not be important to you. Whether any particular feature is an advantage for you will depend on your unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features:

**Professional Management** — Professional money managers research, select, and monitor the performance of the securities the fund purchases.

**Diversification** — Diversification is an investing strategy that can be neatly summed up as "Don't put all your eggs in one basket." Spreading your investments across a wide range of companies and industry sectors can help lower your risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds.

**Affordability** — Some mutual funds accommodate investors who don't have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases, or both.

**Liquidity** — Mutual fund investors can readily redeem their shares at the current NAV — plus any fees and charges assessed on redemption — at any time.

But mutual funds also have features that some investors might view as disadvantages, such as:

**Costs Despite Negative Returns** — Investors must pay sales charges, annual fees, and other expenses (which we'll discuss below) regardless of how the fund performs. And, depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive — even if the fund went on to perform poorly after they bought shares.

**Lack of Control** — Investors typically cannot ascertain the exact make-up of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.

**Price Uncertainty** — With an individual stock, you can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling your broker. You can also monitor how a stock's price changes from hour to hour — or even second to second. By contrast, with a mutual fund, the price at which you purchase or redeem shares will typically depend on the fund's NAV, which the fund might not calculate until many hours after you've placed your order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

## Different Types of Funds

When it comes to investing in mutual funds, investors have literally thousands of choices. Before you invest in any given fund, decide whether the investment strategy and risks of the fund are a good fit for you. The first step to successful investing is figuring out your financial goals and risk tolerance — either on your own or with the help of a financial professional. Once you know what you're saving for, when you'll need the money, and how much risk you can tolerate, you can more easily narrow your choices.

Most mutual funds fall into one of three main categories — money market funds, bond funds (also called "fixed income" funds), and stock funds (also called "equity" funds). Each type has different

features and different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

#### Money Market Funds

Money market funds have relatively low risks, compared to other mutual funds (and most other investments). By law, they can invest in only certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments. Money market funds try to keep their net asset value (NAV) — which represents the value of one share in a fund — at a stable \$1.00 per share. But the NAV may fall below \$1.00 if the fund's investments perform poorly. Investor losses have been rare, but they are possible.

Money market funds pay dividends that generally reflect short-term interest rates, and historically the returns for money market funds have been lower than for either bond or stock funds. That's why "inflation risk" — the risk that inflation will outpace and erode investment returns over time — can be a potential concern for investors in money market funds.

#### Bond Funds

Bond funds generally have higher risks than money market funds, largely because they typically pursue strategies aimed at producing higher yields. Unlike money market funds, the SEC's rules do not restrict bond funds to high-quality or short-term investments. Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards. Some of the risks associated with bond funds include:

**Credit Risk** — the possibility that companies or other issuers whose bonds are owned by the fund may fail to pay their debts (including the debt owed to holders of their bonds). Credit risk is less of a factor for bond funds that invest in insured bonds or U.S. Treasury bonds. By contrast, those that invest in the bonds of companies with poor credit ratings generally will be subject to higher risk.

**Interest Rate Risk** — the risk that the market value of the bonds will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or Treasury bonds. Funds that invest in longer-term bonds tend to have higher interest rate risk.

**Prepayment Risk** — the chance that a bond will be paid off early. For example, if interest rates fall, a bond issuer may decide to pay off (or "retire") its debt and issue new bonds that pay a lower rate. When this happens, the fund may not be able to reinvest the proceeds in an investment with as high a return or yield.

#### Stock Funds

Although a stock fund's value can rise and fall quickly (and dramatically) over the short term, historically stocks have performed better over the long term than other types of investments — including corporate bonds, government bonds, and treasury securities.

Overall "market risk" poses the greatest potential danger for investors in stocks funds. Stock

prices can fluctuate for a broad range of reasons — such as the overall strength of the economy or demand for particular products or services.

Not all stock funds are the same. For example:

- Growth funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains.
- Income funds invest in stocks that pay regular dividends.
- Index funds aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all — or perhaps a representative sample — of the companies included in an index.
- Sector funds may specialize in a particular industry segment, such as technology or consumer products stocks.

#### How to Buy and Sell Shares

You can purchase shares in some mutual funds by contacting the fund directly. Other mutual fund shares are sold mainly through brokers, banks, financial planners, or insurance agents. All mutual funds will redeem (buy back) your shares on any business day and must send you the payment within seven days.

The easiest way to determine the value of your shares is to call the fund's toll-free number or visit its website. The financial pages of major newspapers sometimes print the NAVs for various mutual funds. When you buy shares, you pay the current NAV per share plus any fee the fund assesses at the time of purchase, such as a purchase sales load or other type of purchase fee. When you sell your shares, the fund will pay you the NAV minus any fee the fund assesses at the time of redemption, such as a deferred (or back-end) sales load or redemption fee. A fund's NAV goes up or down daily as its holdings change in value.

#### Exchanging Shares

A "family of funds" is a group of mutual funds that share administrative and distribution systems. Each fund in a family may have different investment objectives and follow different strategies.

Some funds offer exchange privileges within a family of funds, allowing shareholders to transfer their holdings from one fund to another as their investment goals or tolerance for risk change. While some funds impose fees for exchanges, most funds typically do not. To learn more about a fund's exchange policies, call the fund's toll-free number, visit its website, or read the "shareholder information" section of the prospectus.

Bear in mind that exchanges have tax consequences. Even if the fund doesn't charge you for the transfer, you'll be liable for any capital gain on the sale of your old shares — or, depending on the circumstances, eligible to take a capital loss. We'll discuss taxes in further detail below.

## How Funds Can Earn Money for You

You can earn money from your investment in three ways:

**Dividend Payments** — A fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.

**Capital Gains Distributions** — The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.

**Increased NAV** — If the market value of a fund's portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

With respect to dividend payments and capital gains distributions, funds usually will give you a choice: the fund can send you a check or other form of payment, or you can have your dividends or distributions reinvested in the fund to buy more shares (often without paying an additional sales load).

## Factors to Consider

Thinking about your long-term investment strategies and tolerance for risk can help you decide what type of fund is best suited for you. But you should also consider the effect that fees and taxes will have on your returns over time.

## Degrees of Risk

All funds carry some level of risk. You may lose some or all of the money you invest — your principal — because the securities held by a fund go up and down in value. Dividend or interest payments may also fluctuate as market conditions change.

Before you invest, be sure to read a fund's prospectus and shareholder reports to learn about its investment strategy and the potential risks. Funds with higher rates of return may take risks that are beyond your comfort level and are inconsistent with your financial goals.

## A Word About Derivatives

Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways.

There are many types of derivatives with many different uses. A fund's prospectus will disclose whether and how it may use derivatives. You may also want to call a fund and ask how it uses these instruments.

## Fees and Expenses



As with any business, running a mutual fund involves costs — including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses. It is important that you understand these charges because they lower your returns.

Some funds impose "shareholder fees" directly on investors whenever they buy or sell shares. In addition, every fund has regular, recurring, fund-wide "operating expenses." Funds typically pay their operating expenses out of fund assets — which means that investors indirectly pay these costs.

SEC rules require funds to disclose both shareholder fees and operating expenses in a "fee table" near the front of a fund's prospectus. The lists below will help you decode the fee table and understand the various fees a fund may impose:

#### Shareholder Fees

**Sales Charge (Load) on Purchases** — the amount you pay when you buy shares in a mutual fund. Also known as a "front-end load," this fee typically goes to the brokers that sell the fund's shares. Front-end loads reduce the amount of your investment. For example, let's say you have \$1,000 and want to invest it in a mutual fund with a 5% front-end load. The \$50 sales load you must pay comes off the top, and the remaining \$950 will be invested in the fund. According to NASD rules, a front-end load cannot be higher than 8.5% of your investment.

**Purchase Fee** — another type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, a purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund's costs associated with the purchase.

**Deferred Sales Charge (Load)** — a fee you pay when you sell your shares. Also known as a "back-end load," this fee typically goes to the brokers that sell the fund's shares. The most common type of back-end sales load is the "contingent deferred sales load" (also known as a "CDSC" or "CDSL"). The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.

**Redemption Fee** — another type of fee that some funds charge their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to a broker) and is typically used to defray fund costs associated with a shareholder's redemption.

**Exchange Fee** — a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group or "family of funds."

**Account fee** — a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

#### Annual Fund Operating Expenses

**Management Fees** — fees that are paid out of fund assets to the fund's investment adviser for investment portfolio management, any other management fees payable to the fund's investment adviser or its affiliates, and administrative fees payable to the investment adviser that are not

included in the "Other Expenses" category (discussed below).

Distribution [and/or Service] Fees ("12b-1" Fees) — fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. "Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

Other Expenses — expenses not included under "Management Fees" or "Distribution or Service (12b-1) Fees," such as any shareholder service expenses that are not already included in the 12b-1 fees, custodial expenses, legal and accounting expenses, transfer agent expenses, and other administrative expenses.

Total Annual Fund Operating Expenses ("Expense Ratio") — the line of the fee table that represents the total of all of a fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. Looking at the expense ratio can help you make comparisons among funds.

#### A Word About "No-Load" Funds

Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. But, as discussed above, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds will also have operating expenses.

Be sure to review carefully the fee tables of any funds you're considering, including no-load funds. Even small differences in fees can translate into large differences in returns over time. For example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858— an 18% difference.

A mutual fund cost calculator can help you understand the impact that many types of fees and expenses can have over time. It takes only minutes to compare the costs of different mutual funds.

#### A Word About Breakpoints

Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints."

The SEC does not require a fund to offer breakpoints in the fund's sales load. But, if breakpoints exist, the fund must disclose them. In addition, a NASD member brokerage firm should not sell you shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to

earn a higher commission.

Each fund company establishes its own formula for how they will calculate whether an investor is entitled to receive a breakpoint. For that reason, it is important to seek out breakpoint information from your financial advisor or the fund itself. You'll need to ask how a particular fund establishes eligibility for breakpoint discounts, as well as what the fund's breakpoint amounts are. NASD's Mutual Fund Breakpoint Search Tool can help you determine whether you're entitled to breakpoint discounts.

#### Classes of Funds

Many mutual funds offer more than one class of shares. For example, you may have seen a fund that offers "Class A" and "Class B" shares. Each class will invest in the same "pool" (or investment portfolio) of securities and will have the same investment objectives and policies. But each class will have different shareholder services and/or distribution arrangements with different fees and expenses. As a result, each class will likely have different performance results.

A multi-class structure offers investors the ability to select a fee and expense structure that is most appropriate for their investment goals (including the time that they expect to remain invested in the fund). Here are some key characteristics of the most common mutual fund share classes offered to individual investors:

**Class A Shares** — Class A shares typically impose a front-end sales load. They also tend to have a lower 12b-1 fee and lower annual expenses than other mutual fund share classes. Be aware that some mutual funds reduce the front-end load as the size of your investment increases. If you're considering Class A shares, be sure to inquire about breakpoints.

**Class B Shares** — Class B shares typically do not have a front-end sales load. Instead, they may impose a contingent deferred sales load and a 12b-1 fee (along with other annual expenses). Class B shares also might convert automatically to a class with a lower 12b-1 fee if the investor holds the shares long enough.

**Class C Shares** — Class C shares might have a 12b-1 fee, other annual expenses, and either a front- or back-end sales load. But the front- or back-end load for Class C shares tends to be lower than for Class A or Class B shares, respectively. Unlike Class B shares, Class C shares generally do not convert to another class. Class C shares tend to have higher annual expenses than either Class A or Class B shares.

#### Tax Consequences

When you buy and hold an individual stock or bond, you must pay income tax each year on the dividends or interest you receive. But you won't have to pay any capital gains tax until you actually sell and unless you make a profit.

Mutual funds are different. When you buy and hold mutual fund shares, you will owe income tax on any ordinary dividends in the year you receive or reinvest them. And, in addition to owing taxes on any personal capital gains when you sell your shares, you may also have to pay taxes each year on the fund's capital gains. That's because the law requires mutual funds to distribute capital gains to shareholders if they sell securities for a profit that can't be offset by a loss.

**Tax Exempt Funds:** If you invest in a tax-exempt fund — such as a municipal bond fund — some or all of your dividends will be exempt from federal (and sometimes state and local) income tax. You will, however, owe taxes on any capital gains.

Bear in mind that if you receive a capital gains distribution, you will likely owe taxes — even if the fund has had a negative return from the point during the year when you purchased your shares. For this reason, you should call the fund to find out when it makes distributions so you won't pay more than your fair share of taxes. Some funds post that information on their websites.

SEC rules require mutual funds to disclose in their prospectuses after-tax returns. In calculating after-tax returns, mutual funds must use standardized formulas similar to the ones used to calculate before-tax average annual total returns. You'll find a fund's after-tax returns in the "Risk/Return Summary" section of the prospectus. When comparing funds, be sure to take taxes into account.

#### Avoiding Common Pitfalls

If you decide to invest in mutual funds, be sure to obtain as much information about the fund before you invest. And don't make assumptions about the soundness of the fund based solely on its past performance or its name.

#### Sources of Information

##### Prospectus

When you purchase shares of a mutual fund, the fund must provide you with a prospectus. But you can — and should — request and read a fund's prospectus before you invest. The prospectus is the fund's selling document and contains valuable information, such as the fund's investment objectives or goals, principal strategies for achieving those goals, principal risks of investing in the fund, fees and expenses, and past performance. The prospectus also identifies the fund's managers and advisers and describes how to purchase and redeem fund shares.

While they may seem daunting at first, mutual fund prospectuses contain a treasure trove of valuable information. The SEC requires funds to include specific categories of information in their prospectuses and to present key data (such as fees and past performance) in a standard format so that investors can more easily compare different funds.

Here's some of what you'll find in mutual fund prospectuses:

**Date of Issue** — The date of the prospectus should appear on the front cover. Mutual funds must update their prospectuses at least once a year, so always check to make sure you're looking at the most recent version.

**Risk/Return Bar Chart and Table** — Near the front of the prospectus, right after the fund's narrative description of its investment objectives or goals, strategies, and risks, you'll find a bar chart showing the fund's annual total returns for each of the last 10 years (or for the life of the fund if it is less than 10 years old). All funds that have had annual returns for at least one calendar year must include this chart.

**Fee Table** — Following the performance bar chart and annual returns table, you'll find a table that describes the fund's fees and expenses. These include the shareholder fees and annual fund operating expenses described in greater detail above. The fee table includes an example that will help you compare costs among different funds by showing you the costs associated with investing a hypothetical \$10,000 over a 1-, 3-, 5-, and 10-year period.

**Financial Highlights** — This section, which generally appears towards the back of the prospectus, contains audited data concerning the fund's financial performance for each of the past 5 years. Here you'll find net asset values (for both the beginning and end of each period), total returns, and various ratios, including the ratio of expenses to average net assets, the ratio of net income to average net assets, and the portfolio turnover rate.

#### **Profile**

Some mutual funds also furnish investors with a "profile," which summarizes key information contained in the fund's prospectus, such as the fund's investment objectives, principal investment strategies, principal risks, performance, fees and expenses, after-tax returns, identity of the fund's investment adviser, investment requirements, and other information.

#### **Statement of Additional Information ("SAI")**

Also known as "Part B" of the registration statement, the SAI explains a fund's operations in greater detail than the prospectus — including the fund's financial statements and details about the history of the fund, fund policies on borrowing and concentration, the identity of officers, directors, and persons who control the fund, investment advisory and other services, brokerage commissions, tax matters, and performance such as yield and average annual total return information. If you ask, the fund must send you an SAI. The back cover of the fund's prospectus should contain information on how to obtain the SAI.

#### **Shareholder Reports**

A mutual fund also must provide shareholders with annual and semi-annual reports within 60 days after the end of the fund's fiscal year and 60 days after the fund's fiscal mid-year. These reports contain a variety of updated financial information, a list of the fund's portfolio securities, and other information. The information in the shareholder reports will be current as of the date of the particular report (that is, the last day of the fund's fiscal year for the annual report, and the last day of the fund's fiscal mid-year for the semi-annual report).

#### **Past Performance**

A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund.

Be sure to find out how long the fund has been in existence. Newly created or small funds sometimes have excellent short-term performance records. Because these funds may invest in only a small number of stocks, a few successful stocks can have a large impact on their performance. But as these funds grow larger and increase the number of stocks they own, each stock has less impact on performance. This may make it more difficult to sustain initial results.

While past performance does not necessarily predict future returns, it can tell you how volatile (or stable) a fund has been over a period of time. Generally, the more volatile a fund, the higher the investment risk. If you'll need your money to meet a financial goal in the near-term, you probably can't afford the risk of investing in a fund with a volatile history because you will not have enough time to ride out any declines in the stock market.

#### Looking Beyond a Fund's Name

Don't assume that a fund called the "XYZ Stock Fund" invests only in stocks or that the "Martian High-Yield Fund" invests only in the securities of companies headquartered on the planet Mars. The SEC requires that any mutual fund with a name suggesting that it focuses on a particular type of investment must invest at least 80% of its assets in the type of investment suggested by its name. But funds can still invest up to one-fifth of their holdings in other types of securities — including securities that you might consider too risky or perhaps not aggressive enough.

#### Bank Products versus Mutual Funds

Many banks now sell mutual funds, some of which carry the bank's name. But mutual funds sold in banks, including money market funds, are not bank deposits. As a result, they are not federally insured by the Federal Deposit Insurance Corporation (FDIC).

#### Money Market Matters

Don't confuse a "money market fund" with a "money market deposit account." The names are similar, but they are completely different:

A money market fund is a type of mutual fund. It is not guaranteed or FDIC insured. When you buy shares in a money market fund, you should receive a prospectus.

A money market deposit account is a bank deposit. It is guaranteed and FDIC insured. When you deposit money in a money market deposit account, you should receive a Truth in Savings form.

#### Glossary of Key Mutual Fund Terms

**12b-1 Fees** — fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. "Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

**Account Fee** — a fee that some funds separately impose on investors for the maintenance of their accounts. For example, accounts below a specified dollar amount may have to pay an account fee.

**Back-end Load** — a sales charge (also known as a "deferred sales charge") investors pay when they redeem (or sell) mutual fund shares, generally used by the fund to compensate brokers.

**Classes** — different types of shares issued by a single fund, often referred to as Class A shares, Class B shares, and so on. Each class invests in the same "pool" (or investment portfolio) of securities and has the same investment objectives and policies. But each class has different shareholder services and/or distribution arrangements with different fees and expenses and therefore different performance results.

**Closed-End Fund** — a type of investment company that does not continuously offer its shares for sale but instead sells a fixed number of shares at one time (in the initial public offering) which then typically trade on a secondary market, such as the New York Stock Exchange or the Nasdaq Stock Market. Legally known as a "closed-end company."

**Contingent Deferred Sales Load** — a type of back-end load, the amount of which depends on the length of time the investor held his or her shares. For example, a contingent deferred sales load might be (X)% if an investor holds his or her shares for one year, (X-1)% after two years, and so on until the load reaches zero and goes away completely.

**Conversion** — a feature some funds offer that allows investors to automatically change from one class to another (typically with lower annual expenses) after a set period of time. The fund's prospectus or profile will state whether a class ever converts to another class.

**Deferred Sales Charge** — see "back-end load" (above).

**Distribution Fees** — fees paid out of fund assets to cover expenses for marketing and selling fund shares, including advertising costs, compensation for brokers and others who sell fund shares, and payments for printing and mailing prospectuses to new investors and sales literature prospective investors. Sometimes referred to as "12b-1 fees."

**Exchange Fee** — a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group.

**Exchange-Traded Funds** — a type of an investment company (either an open-end company or UIT) whose objective is to achieve the same return as a particular market index. ETFs differ from traditional open-end companies and UITs, because, pursuant to SEC exemptive orders, shares issued by ETFs trade on a secondary market and are only redeemable from the fund itself in very large blocks (blocks of 50,000 shares for example).

**Expense Ratio** — the fund's total annual operating expenses (including management fees, distribution (12b-1) fees, and other expenses) expressed as a percentage of average net assets.

**Front-end Load** — an upfront sales charge investors pay when they purchase fund shares, generally used by the fund to compensate brokers. A front-end load reduces the amount available to purchase fund shares.

**Index Fund** — describes a type of mutual fund or Unit Investment Trust (UIT) whose investment



objective typically is to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

Investment Adviser — generally, a person or entity who receives compensation for giving individually tailored advice to a specific person on investing in stocks, bonds, or mutual funds. Some investment advisers also manage portfolios of securities, including mutual funds.

Investment Company — a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities. The three basic types of investment companies are mutual funds, closed-end funds, and unit investment trusts.

Load — see "Sales Charge."

Management Fee — fee paid out of fund assets to the fund's investment adviser or its affiliates for managing the fund's portfolio, any other management fee payable to the fund's investment adviser or its affiliates, and any administrative fee payable to the investment adviser that are not included in the "Other Expenses" category. A fund's management fee appears as a category under "Annual Fund Operating Expenses" in the Fee Table.

Market Index — a measurement of the performance of a specific "basket" of stocks considered to represent a particular market or sector of the U.S. stock market or the economy. For example, the Dow Jones Industrial Average (DJIA) is an index of 30 "blue chip" U.S. stocks of industrial companies (excluding transportation and utility companies).

Mutual Fund — the common name for an open-end investment company. Like other types of investment companies, mutual funds pool money from many investors and invest the money in stocks, bonds, short-term money-market instruments, or other securities. Mutual funds issue redeemable shares that investors purchase directly from the fund (or through a broker for the fund) instead of purchasing from investors on a secondary market.

NAV (Net Asset Value) — the value of the fund's assets minus its liabilities. SEC rules require funds to calculate the NAV at least once daily. To calculate the NAV per share, simply subtract the fund's liabilities from its assets and then divide the result by the number of shares outstanding.

No-load Fund — a fund that does not charge any type of sales load. But not every type of shareholder fee is a "sales load," and a no-load fund may charge fees that are not sales loads. No-load funds also charge operating expenses.

Open-End Company — the legal name for a mutual fund. An open-end company is a type of investment company

Operating Expenses — the costs a fund incurs in connection with running the fund, including management fees, distribution (12b-1) fees, and other expenses.

**Portfolio** — an individual's or entity's combined holdings of stocks, bonds, or other securities and assets.

**Profile** — summarizes key information about a mutual fund's costs, investment objectives, risks, and performance. Although every mutual fund has a prospectus, not every mutual fund has a profile.

**Prospectus** — describes the mutual fund to prospective investors. Every mutual fund has a prospectus. The prospectus contains information about the mutual fund's costs, investment objectives, risks, and performance. You can get a prospectus from the mutual fund company (through its website or by phone or mail). Your financial professional or broker can also provide you with a copy.

**Purchase Fee** — a shareholder fee that some funds charge when investors purchase mutual fund shares. Not the same as (and may be in addition to) a front-end load.

**Redemption Fee** — a shareholder fee that some funds charge when investors redeem (or sell) mutual fund shares. Redemption fees (which must be paid to the fund) are not the same as (and may be in addition to) a back-end load (which is typically paid to a broker). The SEC generally limits redemption fees to 2%.

**Sales Charge (or "Load")** — the amount that investors pay when they purchase (front-end load) or redeem (back-end load) shares in a mutual fund, similar to a commission. The SEC's rules do not limit the size of sales load a fund may charge, but NASD rules state that mutual fund sales loads cannot exceed 8.5% and must be even lower depending on other fees and charges assessed.

**Shareholder Service Fees** — fees paid to persons to respond to investor inquiries and provide investors with information about their investments. See also "12b-1 fees."

**Statement of Additional Information (SAI)** — conveys information about an open- or closed-end fund that is not necessarily needed by investors to make an informed investment decision, but that some investors find useful. Although funds are not required to provide investors with the SAI, they must give investors the SAI upon request and without charge. Also known as "Part B" of the fund's registration statement.

**Total Annual Fund Operating Expense** — the total of a fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. You'll find the total in the fund's fee table in the prospectus.

**Unit Investment Trust (UIT)** — a type of investment company that typically makes a one-time "public offering" of only a specific, fixed number of units. A UIT will terminate and dissolve on a date established when the UIT is created (although some may terminate more than fifty years after they are created). UITs do not actively trade their investment portfolios.

