An Investor Education Initiative

MIRAE ASSET
Mutual Fund

POTENTIAL WEALTH CREATION THROUGH EQUITY - 2

Topic 1:

How to invest in equities (Equity Mutual Funds)?

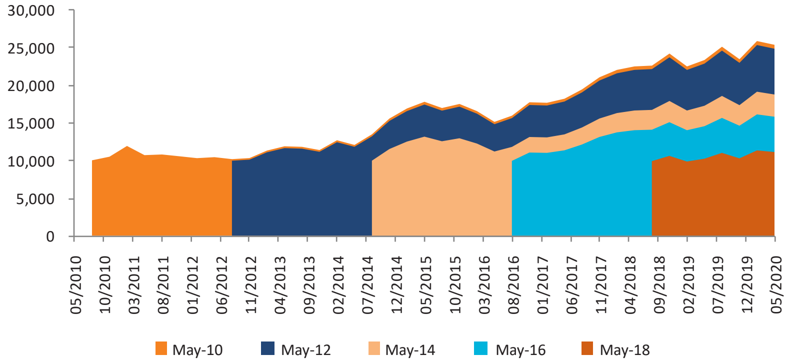
There are two broad ways of investing in equity funds - investing in lump sum (one-time) and investing systematically. Systematic Investment Plan (SIP) and Systematic Transfer Plans (STP) are examples of systematic investments. One mode of investing is not necessarily better than the other methods. It depends on your investment needs and financial position. In this article we will discuss all three methods of investing so that you can make informed decisions.

Lump Sum

Investments in lump sum means that you deploy your entire investable amount at one go. Minimum lump sum investment amount in mutual funds is usually Rs 5,000 but some schemes may accept even lower amounts. Lump sum investments usually imply a significant commitment of funds though what constitutes a significant amount can differ from investor to investor depending on their individual financial situations.

The biggest disadvantage of lump sum investment is that it involves market timing risk unless you have very long investment tenures. Lump sum investments made at market peaks can suffer significant value erosion in ensuing corrections. Investing in lump sum only does not instil the discipline which systematic investment does.

The chart below shows the growth of Rs 10,000 investment in Nifty 50 TRI made at different points in time. You can see that growth of your lump sum investment is dependent on when you invested (more importantly level at which invested). You can see that investment in 2012 grew almost as much as investment made 2 years earlier, but investments made later grew much less.



Source: Advisorkhoj Research.
Past performance may or may not be sustained in future.

Systematic Investment Plan

Systematic Investment Plans (SIPs) are a mode of mutual fund investments by which you can invest a portion of your regular savings for your long term financial goals. You can invest at frequencies like weekly, fortnightly, monthly etc. depending on need and convenience. There are three main benefits of investing through SIP.

Start early and invest for long period:

You do not need to commit large sums of money upfront. You can invest a portion of your regular monthly savings in mutual funds for your long term financial goals. The longer you remain invested the more wealth you may accumulate through the **power of compounding.**

Disciplined Investing:

Greed and fear are the two main reasons why investors lose money or are not able to get returns. SIP makes your investment process **mechanical** and not based on emotions.

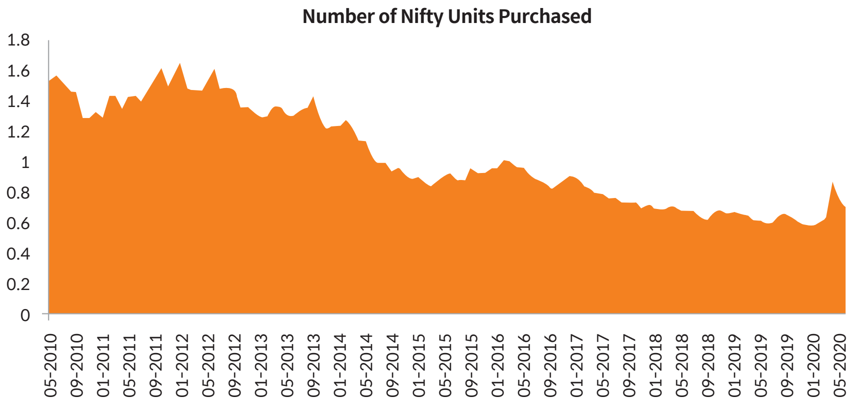
Rupee Cost Averaging:

When investing through SIP, there is no **timing risk** because you buy at **different price points** (both low and high). This is known as Rupee Cost Averaging of purchase price. For example If your SIP amount is Rs 10,000 you will buy 100 units in a month when scheme NAV is Rs 100, 125 units if NAV is Rs 80 and 80 units if NAV is Rs 125. **Rupee cost averaging** usually lowers your acquisition costs during bear markets and may give superior returns in the long term.

Convenience:

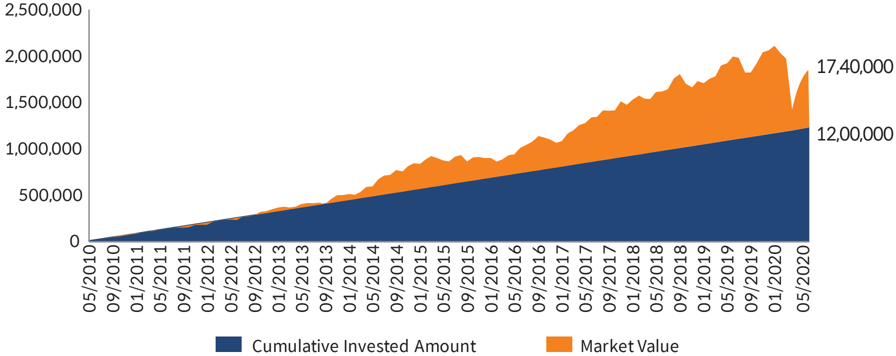
You do not need to check market levels and do paperwork each time you want to invest. Through a one-time application / SIP registration, you can put your financial planning on auto-pilot mode.

The chart below illustrates the cumulative units purchased with Rs 10,000 monthly SIP in Nifty 50 TRI over the last 10 years. In market corrections (e.g. 2011, 2015 etc.) you will purchase more units and in bull markets (e.g. 2012, 2014, 2017 etc.), less units. Over sufficiently long investment tenure you will have both bull and bear market. Hence your cost will get averaged over tenure.



The chart below shows the growth in market value of Rs 10,000 monthly SIP in Nifty 50 TRI over the last 10 years. You can see that with a cumulative investment of Rs 12 lakhs you would have been able to accumulate a corpus of Rs 17.4 lakhs over the last 10 years.

Growth in value of Rs 10,000 monthly SIP over last 10 years



Source: Advisorkhoj Research, As on 30th June 2020.
Past performance may or may not be sustained in future.

Comparison of lump sum and SIP investments is irrelevant because lump sum and SIPs are apples and oranges. If you have lump sum funds available and have a long investment horizon, then you should invest through lump sum.

SIP is for disciplined, systematic investing from your regular savings for your long term financial goals. If you have regular income and savings then you should invest through SIP whether you have additional lump sum funds available or not. In addition to SIP, you should invest tactically in lump sum during volatile markets to take advantage of price corrections.

However, during periods of prolonged volatility you may hesitate to invest in lump sum even if you have funds available. What should you do in such a situation? Let us discuss this in the next section.

Systematic Transfer Plan

Systematic Transfer Plan (STP) is a smart mutual fund investment mode by which an investor is able to transfer a fixed or variable amount from one mutual fund scheme to another mutual fund scheme of the same fund house. If you are investing for the long term and at the same time, are concerned about short term volatility, you can invest your capital in a low risk debt mutual fund (e.g. overnight, liquid, ultra-short term debt fund) and use STP to redeem fixed amounts from your debt mutual fund and transfer the proceeds to equity funds on a regular basis over several months. Through STP you may get potential returns on your lump sum investment in the low risk debt fund and also get advantage of rupee cost averaging of purchase price of the equity fund.

Suppose you want to invest Rs 1 lakh in an equity fund but are worried that the market may be volatile in the next one year. You can invest the money in a liquid fund and use STP to transfer equal amounts to the equity fund every month. Let us assume that the liquid fund gives an annualized return of 6%. The table shows how the STP will work over the next 12 months (NAVs are purely illustrative).

Month	Equity Fund NAVs	Investment in Liquid Fund	Transfer to Equity Fund	Number of Equity Fund Units	Equity Fund Value	Investment Value
Month 0	100	1,00,000	-	-	-	1,00,000
Month 1	95	92,125	8,333	88	8,333	1,00,458
Month 2	90	84,211	8,333	180	16,228	1,00,439
Month 3	85	76,258	8,333	278	23,660	99,918
Month 4	90	68,264	8,333	371	33,385	1,01,649
Month 5	95	60,231	8,333	459	43,573	1,03,804
Month 6	90	52,157	8,333	551	49,613	1,01,770
Month 7	95	44,044	8,333	639	60,703	1,04,747
Month 8	100	35,889	8,333	722	72,231	1,08,120
Month 9	105	27,694	8,333	802	84,176	1,11,870
Month 10	100	19,458	8,333	885	88,501	1,07,959
Month 11	105	11,180	8,333	964	1,01,259	1,12,439
Month 12	110	2,862	8,333	1,040	1,14,414	1,17,276

For illustration purpose only.
Like equity funds, liquid funds are also subject to market risks and cannot give assured returns.

You can see that the equity fund NAV increased from Rs 100 to Rs 110 over the course of the year, but it was volatile on a month on month basis. If you invested your money in the equity fund in lump sum, you would have purchased 1,000 units and the value of your investment at the end of the year would have Rs 110,000. However, using Systematic Transfer Plan you were able to purchase additional 40 units (total 1,040) and the value of your equity investment was Rs 114,414; so you made an additional Rs 4,414 through systematic transfer plan. This is not all. You also had a balance of Rs 3,355 in your liquid fund. Your total investment value at the end of the year was Rs 117,769. Therefore, you were able to make an additional profit of Rs 7,769 through rupee cost averaging of the units and also making your money productive by investing in the liquid fund during the tenure of the Systematic Transfer Plan.

Variants of SIP

There can be several smart variants of SIP and STP which can vary the periodic investment amounts based on your needs.

- **Goal SIP:** Goal SIP can be used for financial planning. You can define yours goals and specify a target value for the goal. He / she can invest from his regular savings through SIP to meet the target / goal.

- **SIP Top – Up:** Through SIP Top – Up you can increase your SIP amounts at regular intervals. Top – Up can be specified either in percentage (e.g. 5%, 10% etc) or fixed amounts (e.g. Rs 1,000, Rs 2,000 etc). You can potentially accumulate a significantly larger corpus using SIP Top – Up.

You should consult with your financial advisor if you want to know more about these smart investment options.

Summary

In this article we have discussed various ways of investing in equity funds. Different ways of investing work for different investment needs and circumstances. You can use any of these three modes or a combination of these modes according to your needs. You should seek the guidance of a financial advisor if you need help in making investment decisions.

Key parameters for comparing equity funds

In this article, we will discuss some key performance measures that you may come across in equity investments. Many of these performance parameters are disclosed by mutual funds on a monthly basis in the monthly scheme factsheets. Before you evaluate performance of mutual schemes based on some of these parameters you should understand what they mean and how they can be used to evaluate scheme performance.

Standard Deviation:

Standard Deviation is a statistical concept. It is a measure of dispersion of monthly returns from the Arithmetic Mean or average. In the world of investments, standard deviation is a measure of risk. Higher the standard deviation, higher is the investment risk and vice versa. In many investment literatures, standard deviation and volatility are used interchangeably.

Sharpe Ratio:

Sharpe Ratio is a measure of risk adjusted returns of a mutual fund. This metric was developed by Nobel Laureate, William Sharpe. **Sharpe Ratio is the excess of average returns over risk free rate divided by the standard deviation.** Usually Treasury Bills rates, overnight inter-bank lending rates (MIBOR) etc., are taken as the risk free rate. Sharpe Ratio tells the investor whether the fund manager delivered high returns by taking more risk or through superior stock selection that will ensure consistent performance in different market cycles. If the return of a fund is high, but the Sharpe Ratio is not high (relative to benchmark), it means that the fund manager has delivered higher returns by taking more risks. If both return and Sharpe Ratio are high (relative to benchmark or product category), it means that the fund manager has delivered good risk adjusted returns.

Sortino Ratio:

One of the drawbacks of Sharpe Ratio is that it does not distinguish between good and bad volatility. If NAV of a scheme goes up sharply, then its volatility or standard deviation will be high, but this is good volatility. If the NAV falls sharply, again the volatility will be high, but this is bad volatility. Investor is mostly concerned with bad volatility or downside risk. **Sortino ratio** is a variant of Sharpe Ratio using downside volatility (i.e. volatility when prices are falling). The formula of Sortino Ratio is the **excess of average returns over risk free rate divided by the downside standard deviation.**

Information Ratio:

Information ratio is the ratio excess of scheme returns over market benchmark index returns and tracking error of returns. Tracking error is the standard deviation of the difference in returns between the scheme and the benchmark. Information Ratio is a better measure of a fund manager’s performance compared to Sharpe and Sortino ratios because of two reasons - Firstly, **Information Ratio** measures performance relative to market benchmark (as opposed to risk free rates in Sharpe and Sortino Ratios). Secondly, information ratio also measures the performance consistency of the fund manager through the tracking error. If the tracking error is low it means that the fund manager is able to outperform the benchmark consistently. Performance consistency is one of the key attributes of mutual fund performance.

Beta:

Beta is a measure of risk of a scheme. Beta broadly tells ushow much price change (for a stock or fund) we can expect, if the market benchmark moves up or down by 1%. The exact mathematical formula of beta is as follows:-

Beta = (Scheme Return - Risk Free Rate) ÷ (Benchmark Return - Risk Free Rate)

The conceptual framework which explains beta is known as Capital Asset Pricing Model. If the beta of a fund is 1.5, risk free rate is 5% and benchmark return is 9%, then scheme return will be 4% X 1.5 + 5% = 11%. On the other hand if benchmark return is -5%, the scheme return will be -10% X 1.5 + 5% = -10%. On other hand if beta is 0.5 and benchmark return is -5%, the scheme return will be -10% X 0.5 + 5% = 0%. Therefore, higher the beta, higher is the risk.

Alpha:

Alpha is the excess return over what a scheme would normally get by taking a certain amount of risk. The exact mathematical formula of alpha is as follows:-

Alpha = **(Scheme Return - Risk Free Rate) - Beta X (Benchmark Return - Risk Free**

Often Alpha calculation is simplified by assuming beta to be 1. In that case, the formula becomes:-

Alpha = **Scheme Return - Benchmark Return**

Let us understand this with the help of an example -

Let us assume risk free rate is 5%, benchmark return is 9% and alpha is 1.5. As per capital asset pricing model, scheme return should be 4% X 1.5% + 5% = 11%. If the scheme actually delivered 13% return, then the alpha is 2%. Where did you get this extra 2%? From a conceptual standpoint, alpha is the value added by your fund manager. Good fund managers should be able create alphas consistently.
Consistently good alphas show the fund manager's ability of superior stock selection and portfolio construction. Irrespective of the scheme beta, you should always try to select schemes which consistently give high good alphas.

Up Market Capture Ratio:

Up Market Capture Ratio is the ratio of a scheme's returns to the benchmark returns during the periods the market (benchmark) was rising. So if the market (benchmark) rose by 10% during a month and the scheme NAV rose by 11%, then up-market capture ratio will be 110%. Up Market Capture Ratio of more than 100% is good because it shows that, the fund manager was able to capture the market upside and deliver even more. However, if the Up Market Capture Ratio of a scheme is lower than 100%, it does not necessarily mean that the scheme's performance is bad. Up Market Capture Ratio of a scheme can be lower than 100% if the fund manager takes lesser risks. In order to determine whether a relatively low Up Market Capture Ratio was a result of fund manager's under-performance or lesser risk preference, we need to see the Down Market Capture Ratio.

Down Market Capture Ratio:

Down Market Capture Ratio is the ratio of a fund returns to the benchmark returns during the periods the market (benchmark) was falling. So if the market (benchmark) fell by 10% during a month and the fund NAV fell by 8%, then down-market capture ratio will be 80%. Down Market Ratio of less than 100% is good because it shows that, the fund manager was able to limit downside risks for the investors. Down market capture ratio is important both from a risk and return perspective. A fund with low down market capture ratio falls less, recovers faster and therefore, can give superior returns in the future, if the up market capture ratio is also high.

High **Up Market Capture Ratio** and low **Down Market Capture Ratio** is the ideal scenario for investors because this shows to them that the fund manager is outperforming both, up and down markets. Low **Up Market Capture Ratio** and low **Down Market Capture Ratio** is not necessarily bad if ratio of the two capture ratios is more than 1. Similarly high **Up Market Capture Ratio** and high **Down Market Capture Ratio** is not necessarily bad if ratio of the two capture ratios is more than 1, but it shows that the fund manager is taken higher risks. Low **Up Market Capture Ratio** and high **Down Market Capture Ratio** is a sign of underperformance.

Portfolio Turnover:

Portfolio turnover of a scheme is the ratio of either the total purchase or total sale of securities (whichever is lower) made by the scheme during the month to the scheme's average assets under management (AAUM). Low portfolio turnover indicates a high conviction buy and hold strategy. Low portfolio turnover also keeps scheme expenses (total expense ratio) low. High portfolio turnover implies higher expenses in terms of transaction costs for the scheme. This may in turn impact the total expense ratio (TER) of the scheme. Higher turnover during certain periods of time may not necessarily be bad because it may be a result of profit booking when the fund manager thinks that the valuations are over-heated. If high portfolio turnover is accompanied by high returns, then it is not a cause of concern. However, if high portfolio turnover is accompanied by low returns, then you need to review your scheme selection.

Total Expense Ratio:

Total expense ratio (TER) is calculated by dividing the scheme's total expenses by its assets under management (AUM). A scheme's expenses include transaction costs (buying and selling securities), registrar and transfer agents, custodian, legal, audit fees, fund management costs, marketing and distribution costs. These costs are recovered from unit holders on daily basis by deducting them when Net Asset Value (NAV) of the scheme is calculated. You should note that the scheme NAVs are net of expenses. Expense ratios of regular plans are higher than expense ratios of direct plans, because expense ratios of regular plans include commissions paid to distributors. TERs are regulated by SEBI in form of ceilings for various AUM slabs. TERs are important for certain categories of equity funds like index funds and ETFs. In these schemes, higher TERs have a direct impact on returns. In the case of actively managed schemes, TERs should be seen relative to the returns, especially alphas generated by the schemes.

Conclusion

In this article, we discussed a number of performance parameters for evaluating equity mutual funds. Some of these parameters may fluctuate from one period to another depending on market conditions. Therefore, it is important to evaluate the performance of a scheme over a sufficiently long period of time across different market conditions. You should also consult with your financial advisor if you need help in selecting schemes for your mutual fund portfolio or reviewing performance of schemes in your mutual fund portfolio.

Topic 3:

How to read a mutual fund factsheet

Factsheet is monthly report published by all AMCs, which has detailed performance and portfolio information on all active schemes of an AMC. Factsheet is a mandatory report and is available online on all the AMC websites. Printed versions of the factsheets are also available in the AMC offices or with your mutual fund distributor. A mutual fund factsheet has very useful information which can help you in making informed investment decisions. In this chapter, we will discuss how to read a factsheet of an equity fund. If you want to make the best use of this chapter, you should have a fund factsheet as ready reference for you to understand the different points and concepts discussed in this chapter.

Fund related information in factsheet:

A factsheet will have information of all the schemes of the AMC. Usually, each scheme has a dedicated page in the factsheet, where you will find performance and portfolio related information. Different AMCs may use formats in their factsheets, but factsheet information can be bucketed in the following sections:-

Basic Fund Information: Type of fund (large cap, midcap, multicap etc), fund manager, allotment date, scheme benchmark, AUM, exit load, Total Expense Ratio (TER), minimum investment amounts, NAV, riskometer, etc.

Dividend History: Dividend payout per unit, record date over the past few years.

Portfolio: Top 10 stocks, Top 10 sectors.

Performance: Performance versus benchmark, point to point returns, SIP returns.

Ratios: Volatility, Sharpe Ratio, Beta, Alpha, Portfolio Turnover.

Some AMCs may provide additional information, but in our view, these 5 afore mentioned sections provide sufficient information for the average investor.

How to use a mutual fund factsheet:

You should know the basic fund information before making any mutual fund investment to make sure that the fund is aligned to your investment needs i.e. risk appetite and financial goals. Dividend history can be useful if you want to invest in dividend options. You should bear in mind though, that mutual fund dividends are paid out of accumulated profits of the scheme at the discretion of the fund house. You should not assume that the fund house (AMC) will maintain the same dividend pay-out rate. The last 3 sections i.e. Portfolio, Performance and Ratios provide very useful insights in selecting a fund, once you have decided which fund category and scheme option (e.g. growth, dividend) to invest in, according to your risk appetite and investment needs. We will next discuss how to use the information on Portfolio, Performance and Ratios from mutual fund factsheets.

Portfolio:

The factsheet provides information on Top 10 stocks and Top 10 sectors in the scheme portfolio. The factsheet also provides the percentage exposure to each of these stocks and sectors. For the average investor, the most important understanding from this section is the degree of portfolio diversification. Is the portfolio too concentrated? What percentage of portfolio holding do the Top 5 and Top 10 stocks constitute? There are no hard and fast rules here, but usually Top 5 stocks should not account for more than 30 – 35% of the portfolio and Top 10 stocks should not account for more than 50 – 55% in a diversified equity funds. Diversified equity funds should also invest across multiple sectors. If your fund is heavily invested in one individual sector, then you will be exposed to higher sector risks. A diversified fund usually should have maximum single sector exposure of around 30%. You should not make investment decisions based on a particular month's portfolio; you should evaluate a portfolio over several months or quarters to understand, if there is concentration risk in the fund.

Performance versus benchmark:

This is the simplest section to read. The factsheet will tell you, how the scheme has performed versus its benchmark over the last 1, 3 and 5 years and since inception. Fund managers are tasked with beating the benchmark over sufficiently long tenures. Scheme performance versus benchmark will tell you whether your fund manager is doing a good job or not. It is however, important to note that fund performance evaluation should always be done over sufficiently long investment periods. A fund may underperform or outperform its benchmark in the short term due to market conditions, fund manager's investment strategy vis a vis market conditions etc, but it does not tell you about the long term performance potential of the fund. In our view, you should evaluate the performance of equity funds over minimum 3 years performance period.

Ratios:

Ratios are the most important performance parameters of a fund. In the previous chapter, we have discussed different performance ratios of equity mutual fund schemes. We will now discuss how to read and use the different performance ratios in the factsheet.

Volatility or Standard Deviation: Volatility or standard deviation is a measure of risk. You should compare a fund's volatility from the factsheet with volatilities of other funds in the same category. While relatively low volatility is good, you should not make investment decisions based on volatility alone.

Beta: While Standard Deviation is a good measure of risk it is difficult for average investors to interpret. A more useful measure of risk is beta which tells us how much a fund NAV can change with market (benchmark) movement. Beta of 1.5 or more means that the fund is riskier than the benchmark, but can also give higher returns. Beta of less than 1 means that fund is less risky than benchmark, but may give lower returns. Beta of around 1 represents benchmark risk and return. You should invest according to risk appetite and consider other factors as well, in addition to beta.

Sharpe Ratio: Sharpe ratio is a measure of a fund's risk adjusted return. You should compare a fund's Sharpe Ratio versus other funds in the same category. Higher Sharpe ratio is better. The weakness of Sharpe Ratio is that it does not distinguish between good and bad volatility and therefore, may not always convey the true fund performance. For example, a low positive Sharpe Ratio may not necessarily mean weak performance. We have to see how the fund performed in high and low markets.

Alpha: Alpha is the best measure of fund's performance because it tells us how much the fund outperformed/underperformed versus the benchmark after factoring in the risk. Alpha is the true measure of value added by the fund manager and fund's generating good alphas consistently will deliver superior returns in the long term. You should compare alphas of different funds before investing. You should invest in funds which generate positive alphas across different market conditions.

Conclusion

In this article, we have discussed how to read mutual fund factsheets. As a rule, you should not invest based on just one factor e.g. last 1 year or 3 year returns. You should consider all the factors discussed in this chapter before making investment decisions. You should always consult with a financial advisor if you need help in understanding a fund's risk and return characteristics and always make informed investment decisions.

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MIRAE ASSET

Mutual Fund

by Mirae Asset Knowledge Academy

It is always advisable to consult your financial advisor before investing.

All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

Follow us on

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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