Mutual Funds Demystified

Sunil Subramaniam
Executive Director- Sales & Marketing
Sundaram BNP Paribas Asset Management

As a recipient of this magazine, it would be safe to assume that you have made an initial investment into a mutual fund and are hence are broadly aware of the benefits of this investment. Unless of course, you have never invested in mutual funds and are sitting in your friend's drawing room and reading this magazine while waiting for him to appear - in which case this article would all the more make sense to you!!! Even if you have invested in mutual funds, this article may help reinforce that wise decision.

This article is the first of a series that attempt to give the layman a brief introduction to mutual funds and in the process simplify some of the jargon associated with the industry.

Let us start with the very basic of basics – INVESTMENT. An investment is nothing but a postponement of your natural desire to spend every bit of money you have earned or inherited, that is CONSUMPTION! Why would someone postpone this beautiful consumption opportunity (because by spending your money appropriately one could enjoy that quality of life TODAY) ?

1. One is not satisfied with the current possible quality of life that consumption could generate and hopes that by investing the money, he could aspire for a BETTER quality of life in the future, or
2. One knows that there is a specific need for money at a future date, or
3. One is aware that his earning capacity is limited for a specific period of time whereas the life expectancy could outlast that timeframe or
4. All of the above!!

So the basic premise behind investing is that the investment action would result in your money growing at a rate at least faster than the rise in cost of living (otherwise known as inflation) to fulfill your goals.

Now, just because you have decided to invest your money, it does not mean that there is another person or company willing to accept the same and give you your expected or desired rate of return or better. This will be possible only if that other person/company has the avenue to invest the money and expect to earn, not only at the rate assured to you but at least slightly more. Only then he would also have achieved a similar objective to yours (one of the three outlined above as the rationale for your investment decision)!!! This is also true for the next person who takes the money from your recipient and so on. The process however, would have to stop at one point where the recipient does not find any one willing to accept the money at an acceptable rate; he is unable deploy the money profitably.

The only way this cycle can continue is due to the existence of the glorious word called UNCERTAINTY - the removal of the assured nature of the return or even the assurance of the return of the original capital that is invested!!

Because of the uncertainty associated with some investments, it is possible for the investor and the borrower to have a different evaluation of the consequences of the various uncertain outcomes and hence come to a mutually acceptable rate of return that leaves both happy!!

This is where a MUTUAL FUND steps in –

A Mutual Fund is nothing but the pooling together of the individual investments of hundreds (or even thousands) of people. It operates in that wonderful space known as the equity market as well as fixed-income market and obtains the best possible return commensurate with the risk taken with your investment!!! How does a mutual fund do this?

1. BARGAINING POWER: by pooling together all the moneys invested by several hundreds of people, it gets a sizeable corpus to bring the power of SIZE to the table.
2. RESEARCH AND ANALYSIS: The pooled resources also enable the fund to buy the best possible resources (research, analysts, and fund managers) to analyze, evaluate and decide the appropriate price for the risk and the opportune moment to take advantage.

The mutual fund distributes the gains from the pooled resources equally to all the investors in proportion to their original investment. Thus effectively the resources of each individual investor have been combined together for the mutual benefit of all of them – Hence the name MUTUAL FUND!

That's all for now – we shall continue to look at this world in more detail in the next issue of the magazine.