

# Mutual funds demystified

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As we are reaching out to a significantly larger cross-section of investors from this month, we present a quick summary of the thought process outlined so far:

- Investment is nothing but a postponement of consumption.
- Investment is done in the expectation that Positive Wealth Creation (PWA) would occur as a result of the investment process.
- PWA ensures that the investor would be in a position to achieve higher consumption at a later stage, if he so desires.
- As money is a circulating asset, for PWA to occur, each successive receiver of the 'invested money' has to pay a higher cost (which translates into return for the investor) than the previous receiver.
- Why would any 'receiver of money' pay a higher cost than any other? Answer: difference in ability and/or willingness to take risk.
- Why does risk arise? This is because of the uncertainty on whether

- o He would pay the agreed rate of return.
- o He would pay the agreed payments on time (either the returns or of the principal!)
- o He would repay the principal at all!
- Also, for PWA to occur, an investor's capital would have to grow at a faster rate than the rise in the cost of living (otherwise known as inflation).
- To summarize, the two main factors influencing PWA are the existence of uncertainty (risk) and the existence of inflation.
- Positive Wealth Accretion occurs if the return on the invested money is greater than sum of price per unit of risk and the rate of inflation
- The present rate of inflation is generally available from public sources such as the government data ([www.finmin.nic.in](http://www.finmin.nic.in)) or Reserve Bank of India ([www.rbi.gov.in](http://www.rbi.gov.in)) in terms of parameters such as the consumer price index and wholesale price index. Using this as the basis, the future rate of inflation expected to occur over the investment period can be estimated.
- Different market participants have an estimate of risk and inflation, which is actually reflected in the price they are willing to pay (or receive) for the investment depending on whether they are a buyer or a seller.
- Market forces - **law of demand & supply** - determine the actual price at which the buying/selling occurs.
- The market price of the investment in the case of the equity markets is nothing but the share price of a company.
- Share price is nothing but the **value of the company** divided by the number of shares outstanding.
- The **value of a company** is the sum total of the present value of all cash flows that the company is expected to earn in the future.

- We all know that **a rupee tomorrow is worth less than a rupee today!** Why? The reason is a rise in the cost of living (inflation). Hence we cannot simply add up the numbers of every year straightaway as they will occur at different points of time.
- Before adding up the cash flows, we apply a correction factor to each future year's figure. This correction factor is called the **discounting rate**.
- What the discounting rate does is to bring all the future value to **'today's value'** - put the numbers of different years on equal terms so that they can be easily added up.
- The rate to be used for discounting should be at least equal to the 'best' rate of return that he could get from any alternative investment!!! This is known as 'opportunity cost' because by choosing to make this particular investment, he has lost or foregone the 'opportunity' to invest in some other asset. Hence, the rate that is generally used for discounting is called the **opportunity cost of capital**
- We should bear in mind that cost of capital is nothing but a rate expressed in percentage terms.
- In arriving at the components – the base component is the **'real risk free rate of interest'**. The word 'real' is used here in different sense from its normal everyday English language usage and in the financial world means **the rate equal to the inflation-free rate**. The opposite of this is the rate of interest that incorporates the inflation rate and this is called as the **nominal rate**.
- Thus, the next step in computing the cost of capital automatically follows: we add the expected rate of inflation to the real rate of interest. When we add this, we get the **nominal risk free rate of return**.
- **Cost Of Capital = Real Risk Free Rate + Inflation Rate + Premium To Compensate For Taking The Risk.**

We will take forward the column from the next month.

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