International Journal of Commerce and Management Research
ISSN: 2455-1627
www.managejournal.com
Volume 1; Issue 1; November 2015; Page No. 100-102

Mutual fund and risk factors associated with it

Rachit Agarwal

Research Scholar, Bundelkhand University, Jhansi, Uttar Pradesh, India

Abstract

A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. While there is no legal definition of the term "mutual fund", it is most commonly applied to so-called open-end investment companies, which are collective investment vehicles that are regulated and sold to the general public on a daily basis.

Mutual funds may invest in many kinds of securities. The types of securities that a particular fund may invest in are set forth in the fund's prospectus, a legal document which describes the fund's investment objective, investment approach and permitted investments.

Keywords: Mutual Fund, Risk, Investment

Introduction

Mutual funds have both advantages and disadvantages compared to direct investing in individual securities. Today they play an important role in household finances, most notably in retirement planning.

There are three types of mutual funds: open-end funds, unit investment trusts, and closed-end funds. The most common type, open-end funds, must be willing to buy back shares from investors every business day.

Exchange-traded funds (ETFs) are open-end funds or unit investment trusts that trade on an exchange. Non-exchange-traded open-end funds are most common, but ETFs have been gaining in popularity.

Mutual funds are generally classified by their principal investments. The four main categories of funds are money market funds, bond or fixed income funds, stock or equity funds, and hybrid funds. Funds may also be categorized as index (or passively managed) or actively managed.

Investors in a mutual fund pay the fund's expenses, which reduce the fund's returns and performance. There is controversy about the level of these expenses.

The characterization of a fund's income is unchanged when it is paid to shareholders. For example, when a mutual fund distributes dividend income to its shareholders, fund investors will report the distribution as dividend income on their tax return. As a result, mutual funds are often called "pass-through" vehicles, because they simply pass on income and related tax liabilities to their investors.

The investment objective describes the type of income that the fund seeks. For example, a capital appreciation fund generally looks to earn most of its returns from increases in the prices of the securities it holds, rather than from dividend or interest income. The investment approach describes the criteria that the fund manager uses to select investments for the fund.

Investments are subject to market risks such as absence of liquidity in markets or fluctuations in market prices beyond the control of the managers, resulting in investment objectives of the scheme not being achieved.

NAV can move up or down on the basis of capital market movements. Past performance of the sponsor/AMC/mutual fund is not indicative of the future performance of the scheme. Name of the scheme does not indicate its quality or prospects. Risks associated with the use of derivative instruments, if the fund plans to use such instruments as permitted by SEBI.

For assured returns schemes, if assurance is up to the maturity of the scheme, it must be stated that this is on the basis of guarantee given by the sponsors/trustees/AMC. If assurance is for a specific period, it must be stated that there is no guarantee for sustaining the assured return for the remaining duration of the scheme.

Research Study

In case of non-fulfillment with either of the aforesaid conditions in a three Months time period or the end of succeeding calendar quarter, whichever is earlier, from the close of the NFO of the Scheme, the Scheme shall be wound up by following the guidelines prescribed by SEBI.

The aforesaid conditions should also be met in each subsequent calendar quarter thereafter on an average basis. SEBI has further prescribed that if any investor breaches the 25% limit over a calendar quarter, a rebalancing period of one month will be allowed to the investor and thereafter the investor who is in breach of the limit shall be given 15 days' notice to redeem his exposure over the 25% limit.

In the event of failure on part of the said investor to redeem the excess exposure, the excess holding over the 25% limit will be automatically redeemed by the Mutual Fund on the Applicable NAV on the 15th day of the notice period.

The liquidity of investments made in the Scheme may be restricted by trading volumes and settlement periods. Different segments of the Indian financial markets have different settlement periods and such periods may be extended significantly by unforeseen circumstances. The Trustee has the right, in its sole discretion, to limit Redemptions (including suspending Redemption) under certain circumstances.

There may be temporary periods when the monies of the Scheme are uninvested and no return is earned thereon. The inability of the Scheme to make intended Securities purchases, due to settlement problems, could cause the Scheme to miss

certain investment opportunities. By the same token, the inability to sell Securities held in the Scheme's portfolio due to the absence of a well-developed and liquid secondary market for debt Securities could result, at times, in potential losses to the Scheme, should there be a subsequent decline in the value of the Securities held in the Scheme's portfolio.
The liquidity and valuation of the Scheme's investments due to its holdings of unlisted securities may be affected if they have to be sold prior to their target date of divestment.
Securities, which are not quoted on the stock exchanges, are inherently illiquid in nature and carry a larger amount of liquidity risk, in comparison to Securities that are listed on the exchanges or offer other exit options to the investor, including a put option. Within the Regulatory limits, the AMC may choose to invest in unlisted securities that offer attractive yields.
While Securities that are listed on the stock exchange carry lower liquidity risk, the ability to sell these investments is limited by the overall trading volume on the stock exchanges. Money market Securities, while fairly liquid, lack a well-developed secondary market, which may restrict the selling ability of the Scheme and may lead to the Scheme incurring losses till the Security is finally sold.
Money market Securities and debt Securities are subject to the risk of an issuer's inability to meet interest and principal payments on its debt obligations (credit risk). Credit risk or default risk refers to the risk which may arise due to default on the part of the issuer of the fixed income security (i.e., will be unable to make timely principal and interest payments on the security). Because of this risk debentures are sold at a yield spread above those offered on treasury securities, which are sovereign obligations and generally considered to be free of credit risk.
Normally, the value of a fixed income security will fluctuate depending upon the actual changes in the perceived level of credit risk as well as the actual event of default. These securities may also be subject to price volatility due to factors such as changes in interest rates, general level of market liquidity and market perception of the creditworthiness of the issuer, among others (market risk).
The Liquidity Risk refers to the ease at which a security can be sold at or near its true value. The primary measure of liquidity risk is the spread between the bid price and the offer price quoted by a dealer. Liquidity risk is characteristic of the Indian fixed income market. The Investment Manager will endeavor to manage credit risk through in-house credit analysis.

Risk Factors Associated With Mutual Fund

i) Spread Risk

It is the extent the benchmark index fails to capture interest rate changes appropriately though the basis (i.e. benchmark) gets readjusted on a regular basis, the spread (i.e. markup) over benchmark remains constant. This can result in some volatility to the holding period return of floating rate instruments.

ii) Settlement Risk (counterparty risk)

Specific floating rate assets may also be created by swapping a fixed return into a floating rate return. In such a swap, there is the risk that the counter party (who will pay floating rate return and receive fixed rate return) may default.

iii) Liquidity Risk

The market for floating rate securities is still in its evolutionary stage and therefore may render the market illiquid from time to time, for such Securities that the Scheme is invested in.

Risk Factors Associated with the use of Derivatives

Derivatives products are leveraged instruments and can provide disproportionate gains as well as disproportionate losses to the investor. Execution of such strategies depends upon the ability of the fund manager to identify such opportunities.
Identification and execution of the strategies to be pursued by the fund manager involve uncertainty and the decisions of a fund manager may not always be profitable. No assurance can be given that the fund manager will be able to identify or execute such strategies.
The risks associated with the use of derivatives are different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. As and when the Scheme trades in derivative products, there are risk factors and issues concerning the use of derivatives that investors should understand.
Derivatives require the maintenance of adequate controls to monitor such transactions and the embedded market risks that a derivative adds to the portfolio. Besides the price of the underlying asset, the volatility, tenor and interest rates affect the pricing of derivatives.

i) Credit Risk

This occurs when a counterparty defaults on a transaction before settlement and, therefore, the Scheme is compelled to negotiate with another counterparty at the then prevailing (possibly unfavorable) market price, in order to maintain the validity of the hedge.

ii) Market Liquidity Risk

This is where the derivatives cannot be sold (unwound) at prices that reflect the underlying assets, rates and indices.

iii) Model Risk

This is the risk of mispricing or improper valuation of derivatives.

iv) Basis Risk

This is when the instrument used as a hedge does not match the movement in the instrument / underlying asset being hedged. The risks may be inter–related also; for e.g. interest rate movements can affect equity prices, which could influence specific issuer / industry assets.

Significance of the Study

The Scheme may also, but is not obliged to, use various hedging products from time to time, as are available and permitted by SEBI, to attempt to reduce the impact of undue market volatility on the Scheme's portfolio. There is no guarantee that hedging techniques will achieve the desired result.
The investments made by the Scheme are subject to reinvestment risk. This risk refers to the interest rate levels at which cash flows received from the Securities in the Scheme are reinvested. The additional income from reinvestment is the "interest on interest" component. The risk is that the rate at

which interim cash flows can be reinvested may be lower than that originally assumed. The risk refers to the fall in the rate for reinvestment of interim cash flows.

The NAV of the Scheme's Units, to the extent that the Scheme is invested in fixed income Securities, will be affected by changes in the general level of interest rates. When interest rates decline, the value of a portfolio of fixed income Securities can be expected to rise. Conversely, when interest rates rise, the value of a portfolio of fixed income Securities can be expected to decline.

Conclusion

To the extent the Scheme's investments are in floating rate debt instruments or fixed debt instruments swapped for floating rate return, they will be affected by interest rate movement (basis risk) - coupon rates on floating rate securities are reset periodically in line with the benchmark index movement. Normally, the interest rate risk inherent in a floating rate instrument is limited compared to a fixed rate instrument.

Changes in the prevailing level of interest rates will likely affect the value of the Scheme's holdings until the next reset date and thus the value of the Scheme's Units. The value of securities held by the Scheme generally will vary inversely with changes in prevailing interest rates.

References

1. Lemke Lins, Smith, Regulation of Investment Companies, Chapter 3 Matthew Bender, 2016 ed.
2. Lemke Lins, Smith, Regulation of Investment Companies Matthew Bender, 2016 Ed.
3. Lemke Line, McGuire. Regulation of Exchange-Traded Funds Matthew Bender, 2015 Ed.
4. Legal Information Institute. Cornell University Law School. Retrieved 9 March 2015; 851:b2, 3
5. Pozen Robert, Hamacher Theresa. The Fund Industry: How Your Money is Managed (Second Edition). John Wiley & Sons. 2014, 4-5.
6. Pozen, Hamacher. 2014, 7-8.
7. Geert Rouwenhorst K. The Origins of Mutual Funds, Yale ICF Working, 2004, 04-48.
8. Fink, Matthew P. The Rise of Mutual Funds. Oxford University Press. 2008, 9.