CREATING WEALTH WITH MUTUAL FUNDS

SBI MUTUAL FUND
A PARTNER FOR LIFE

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Outlook Money

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It doesn't matter whether you are an aggressive or a conservative investor. Mutual funds help create wealth for your long- and mid-term goals

The general perception is that if one had more money at one's disposal, one would have a better plan to use it properly. However, the reality is if you have a better plan, you would make more money. Most of us believe that it is necessary to secure our and our family's future, but what prevents us from doing this is the lack of funds. This is where most of us go wrong and miss the early-bird advantage. However, with the right planning and approach, you too can achieve your financial goals with whatever little you mange to save. Mutual funds (MFs) provide a safe and easy option in creating wealth. Here is a step-by-step guide to help you create wealth through MFs

WHY MUTUAL FUNDS

An MF is a financial product that pools money from different individuals and invests it on their behalf into various assets, such as equity, debt or gold. Based on one's financial goal or risk appetite, there are several MF schemes to choose from. Some of the key features of MFs are simplicity, affordability, professional management, diversification and liquidity. MFs give investors the flexibility to invest in the various asset classes. Also, unlike several other financial products, MFs give you the freedom of not having to invest on a continuous basis. You can stop your investment in an MF scheme when there is no cash flow. That said, your invested amount will have the potential to grow till you decide to liquidate it.

LOW COST OF ACQUISITION OF HIGH QUALITY ASSETS

MFs also give you the freedom from tracking the stockmarket on a daily basis to search for the right stock at a fair price and right valuation, as well

as the need to monitor economic policies and news that affect stocks and the various sectors you have invested in through direct equity or MFs.

One of the biggest benefit of MF investments is that you don't need to be a financial expert. The investment decision is taken by investment experts, such as fund managers, who help you manage your money professionally. In lieu for their services, sector regulator Sebi has allowed them to charge a small percentage of the entire corpus money that they manage in the MF scheme, making MFs very cost-efficient. These, together with the flexibility to invest in either a lump sum or in small amounts, makes MFs one of the best instruments to create wealth over the long term. As mentioned earlier, the flexibility to invest in various asset classes and the freedom from having to invest on a continuous basis, do not affect your cash reserves drastically and your invested money has a growth potential that you could depend on. Therefore, MFs are an excellent tool for creating wealth over the long term.

THE FIRST STEP

Budgeting. Budgeting will help you keep your purse strings tight. This effectively translates into savings that you can invest for your long term financial goals, such as home buying, children's education and your own retirement. Budgeting helps you to cut down your bills, such as telephone, grocery and the like. This will also help you in reducing the frequent expenditure on outings, movies and dinning at restaurants. In effect, you will be able to put a fix on your regular expenses every month and the amount you can save (were you to cut down on certain expenses) and channelise the same into your investments.

Savings and investments. Merely saving will not help you create wealth, unless you invest it into financial instruments that can generate inflation-beating returns. Also, the earlier you start investing, the more wealth you can create. An early beginning in all walks of life is a good recipe for success and the same holds true for investing. Early birds have an advantage over those who are off the blocks late. They manage to save a decent pile for all their requirements with less hassles. The essence is to invest early and remain invested for long, so that your money gets the maximum time to grow to the required levels and at the required time.

POWER OF COMPOUNDING

Power of compounding gives you the edge—the more time your money gets to grow, the more you gain. If you start saving early, even in small amounts, it will help you build a sizeable corpus. The rule is to invest regularly and keep investing the returns. As a result, your earnings will also participate in getting more returns.

For example: X starts investing ₹2,500 per month at 25 years, while Y, who is of the same age as X starts investing ₹5,000 per month ten years later. When both X and Y turn 45, X would have amassed a sizeable corpus of ₹22.78 lakh, while Y will have only half as much (₹11.09 lakh), i.e., on a 12 per cent

return, despite Y investing more than X.

An early start to investing in equity MF schemes also inculcates discipline as you invest regularly. Stockmarkets remain volatile on the short-to-medium term, but average-out over the longer horizon. An investor, who remains invested over the long term even during the ups and downs of the stockmarket, is largely unaffected. And, most importantly, mistakes made during the initial days helps one learn the basics of investing, which in turn, helps you become a mature investor.

SELECTION OF FUNDS

Although investing in an MF scheme relatively carries less risk compared to investing directly in the capital market, one must exercise caution while selecting the right MF scheme, especially if the investment is for meet-

ing long-term goals. One must assess the targeted MF schemes on certain criteria.

Performance over long term. Consistency pays over the long term. So, instead of choosing a fund on their short-term performance, one should look at their long-term performance. This will give you an idea of how the fund has performed during different market conditions. That said, the performance of schemes within the same fund family may vary as they are managed by different fund managers and different schemes have different objectives. So, take a close look at the targeted scheme's performance vis-à-vis its benchmark and its peers.

MFs and your risk profile. You can rank the various schemes on a risk-return scale. In descending order of risks, sector-specific schemes top the list. These are followed by growth schemes, balanced schemes, debt schemes and gilt schemes.

No matter how aggressive one's risk profile is to take exposure in equities, the lesser volatile debt asset always remains an essential component of one's investment portfolio. Choosing the right debt fund can be important as they can either be long-or short-term funds and, therefore, should match your financial requirement.

For goals which are about three years away, park in long-term income funds which hold securities of longer durations. Portfolios with higher maturity could earn better returns in a falling interest rate scenario and volatility is capped as funds are not exposed to equities. For goals less than three years, use short-term debt funds. When the requirement for funds is within a year, look at liquid funds. These funds along with ultra short-term debt funds can also be considered for requirements arising in 3-6 months. Parking funds in debt funds as per the tenure of the goal also adds tax advantage when compared to bank fixed deposits especially for investors in highest tax slab.

Most MF schemes offer a choice between a growth and a dividend option. If your objective is to accumulate wealth, choose the growth option. But, even if you opt for a dividend plan, you can choose the reinvestment facility, wherein the dividend is automatically reinvested in the scheme.

In a nutshell, play by the rules while

drawing up an MF portfolio.

Categories and how they work. You must know the broad categories of schemes, their purpose and how they work. For instance, you must know the difference between income funds and gilt funds—what they invest in, what influences their performance and the kind of returns they are likely to deliver. This will help you zero in on the schemes that match your risk profile and investment objective.

Respect your risk-taking capacity. Don't go overboard with equities if you are not comfortable taking on the risk involved. Keep your bigger investment goals (buying a car, house, your own wedding expenses, children's education and their wedding, and your retirement) in mind when you draw up your portfolio. For instance, if the goals are in the distant future, you may take certain risks and invest the money in equity funds. Equities have the potential to outperform all other asset classes over the long term.

Diversifying your portfolio. Don't diversify just for the sake of diversification. There should be a logic to it—what you want from your investment and how much risk you are willing to take. Don't over-diversify within asset classes—three schemes in a category at most. One of the primary reasons to opt for MFs is that you don't want to spend a lot of time on your investments. But that's what you'll end up doing if you diversify your corpus across too many schemes. Moreover, the incremental diversification benefit keeps falling with each new scheme you invest in within a category. So, keep your broad asset mix in mind, but allow flexibility to capitalise on opportunities of a dynamic market.

REGULAR SAVINGS: SIP WAY

A systematic investment plan (SIP) allows an investor to invest a specific amount in an MF scheme of his or her choice over a certain period. While SIPs are available for all MF schemes, they are most effective in equity schemes, as they are a more volatile asset class than debt. SIPs help in regular savings as well as in riding on the volatility of the equity market.

An ideal way to profit from stockmarket volatility is to buy units when it is trading low and sell them when it is at a high. But that's easier said than done. It is here that SIPs come in handy. They help an investor buy more units when prices are falling and fewer units when prices are rising. When the net asset value (NAV) of an MF scheme falls because of a stockmarket crash, you accumulate more units at lower rates, while in a rising stockmarket you are allotted fewer units.

Over long periods, SIPs help lower the average purchase price of units. At most times, your average unit cost will always be below your average sale price per unit, irrespective of whether the stockmarket is rising or falling. Only in extremely bearish phases will an SIP investor book a loss.

Technically, SIPs keep the average purchase price of units down, without having you to second-guess the stockmarket situation. Besides, the in-

vestment in instalments (since an SIP investment involves investing a fixed amount at regular intervals into an MF scheme), help you achieve a higher return from equities than other investment methods. SIPs are most-effective over long periods of time—the investor profits from the appreciation equities tends to show over the long term.

MAKE YOUR WEALTH GROW WITH EQUITY MFs

Schemes that invest in equity shares of companies are called equity MF schemes. As an asset class, equities have the potential of providing high returns with an acceptable levels of risk, but the challenge lies in understanding the behaviour of equity markets over a long period of time—not a year or three, but at least over a decade or more.

Though volatile in nature, equity as an asset class has delivered the best returns over a 10- or 15-year period or more. In the last 10 years, the average return from equity funds has been more than 20 per cent (source: Icra). So, if you are investing for your long-term financial goals, equity is a must-have in your portfolio. But in the short-run, the risk of investing in equities is far more. The last few years witnessed a volatile stockmarket and this might have eroded your capital. Also, in order to create wealth over the long term, one needs to put savings into assets that can deliver inflation-beating returns. Or else, inflation will eat into your returns and it will not help you in accumulating the corpus to see you through. Whatever the risk profile or the quantum of savings you may have, it's imperative to use equity-backed investment products to cancel the effect of inflation.

The veracity of using equity to meet long-term goals have been proven time and again. Studies done in the past have shown that equity has delivered higher inflation-adjusted return than any other asset class. The underlying message is the time horizon—the longer one remains invested in equities, the better is the return. As mentioned earlier, the advantage comes from the power of compounding because the earlier you start, the more time your money gets to grow. If you start saving early, even in small amounts, it will help build a sizeable savings portfolio.

One must begin investing in equity through MFs. Investing into direct equity (stockmarket) with little or no knowhow could be disastrous. That said, an early beginning in investing through equity MF also inculcates a disciplined and safe way of navigating the volatile stockmarket.

OPTIONS WITHIN EQUITY

Equity MFs come with multiple variations within the category, depending on the type of stocks they use to build the portfolio. Needless to say, the risks associated with each equity MF scheme also vary.

Depending on the objective of an MF scheme, the fund manager invests in small-, medium- or large-cap stocks or in a mix of the three. Each fund has its own distinguishing objective and a risk-reward grid. So, understanding them is important in order to align one's financial objective with that of the fund to generate optimum result.

Large-caps. Typically, a large cap MF would invest in the shares of companies that have a market capitalisation (market price of share multiplied by shares outstanding) of more than ₹5,000 crore. Generally, these funds are well-diversified among the top 30, 50, 100 or 200 stocks, and stick to stocks that have a high level of trading volume—thus, imparting enough liquidity to the portfolio. These are the least-risky among diversified equity funds, as shares of large-cap companies are considered to be among the best-known and most researched.

They provide stable growth during periods when the stockmarkets are in a bull phase and tend to have lesser declines during downturns. Ideally, these funds should form the core of your investment portfolio and will be the main growth engine.

Mid- and small-caps. MF schemes that invest in shares with a market capitalisation of anywhere between ₹1,000 crore and ₹5,000 crore are mid-cap funds. Small-cap funds target those with lower market capitalisation—anything less than ₹1,000 crore. Mid- and small- cap funds are more risky as they invest in relatively smaller companies, which are in the growing stage and may be under-researched. As such, funds venture into the relatively unknown, and, therefore, the risk-reward ratio is also high. The mid- and small-cap segment is a good investment opportunity for long-term investors who have considered both the returns and the risks. Before you decide to invest in a mid-cap fund, remember that it cannot form the foundation of your portfolio. It should be included only to the extent permitted by your risk profile to enhance the returns from your portfolio.

Multi-cap. While it's the large-caps that take the centrestage, at times, mid-caps are considered favourites. Typically, no investor should change his or her MF portfolio to reflect the current stockmarket trends, since equity MF investments are always made to fulfil long-term financial goals. But, sometimes, to cater to such immediate tweaks in the portfolio, one may consider multi-cap funds, which invest across the spectrum of market capitalisation with a mix of large- and mid-cap stocks.

STABILISING YOUR WEALTH WITH DEBT FUNDS

Derisking. Putting to use debt funds during the derisking phase helps. With about three years away from meeting your goal, start shifting funds from volatile equity into less volatile debt funds. Either switch funds in lump sum or use the systematic transfer plan (STP) to shift funds from equity to debt funds. The STP mandate will shift funds from existing equity scheme to any debt scheme of same fund house or another over regular period such as monthly or quarterly. As the shifting is staggered not all funds move out of equity in one go.

Regular income for retirees. Debt funds may be put to use by retirees too especially when they depend on regular income. For this use the systematic withdrawal plan (SWP), mostly available with debt schemes to fetch regular income. Basically, it's a payment plan that lets you withdraw pre-decided amounts from your investments at periodic intervals. There are two options in an SWP—fixed withdrawals, in which you specify the amounts you wish to withdraw from your investment on a regular basis, and appreciation withdrawal, in which you can withdraw your appreciated amount. For those in the highest tax bracket, the fixed withdrawal option is more suitable and that too after holding on to the scheme for a year.

TAX-SAVING MUTUAL FUNDS TO CREATE WEALTH

An MF investment also helps in planning one's taxes and thereby reducing the tax burden. Investing in specific MF schemes called Equity-linked Savings Schemes, popularly known as ELSS, reduces one's taxable income by the amount invested (up to ₹1 lakh as per Section 80C of the Income Tax Act, 1961) and, thereby, reduces his or her tax liability. ELSS could be the starting point for new investors, as it offers market-linked returns with shorter lock-in period, as well as the benefits of tax-saving.

ELSS can be used for creating wealth to meet your long-term financial goals.

As the name suggests, an ELSS is a savings scheme that's linked to equity. Investment avenues for your savings can be a mix of various asset classes, such as equity, debt, gold and real estate. Technically, an ELSS is similar to any diversified equity MF, which routes your investments into the equity markets. Like any other MF scheme, ELSS is also managed by professionals known as fund mangers. It stands apart from a normal MF as it carries a tax benefit on the amount invested and, thereby, has a lock-in period of three years. Before you invest in an ELSS, estimate your total tax liability for the year. Then, based on your risk profile, choose among various tax savings instruments, including ELSS, and link it individually to your long-term goals. If properly chosen and cautiously maneuvered, ELSS can be a good kicker in your MF portfolio over the long term.

MFs FOR HOME-BUYING

For all of us who are still living in rented accommodation, the major irritant is spending our hard-earned money on rent (an expense), when we can probably pay the same, or a little more, as equated monthly instalments (EMIs) to service a home loan and help build one's home. This becomes all the more important given that property prices have settled down a bit and home loans are cheaper than before. Housing finance companies are also falling over each other to woo you.

Owning a home is a compelling goal, and saving for a downpayment is certainly a priority. If you feel that it is the right time for you to buy a house, create a savings plan for your downpayment. Get an idea of the purchase price and the EMI payments you can afford. Estimate what you'll need for a downpayment and, thereafter, calculate the amount of savings you need every month at a reasonable return of about 12 per cent per annum.

Taking adequate risk when time horizon is less. If the time horizon is less, i.e., just a year or so away, it is better to stash funds in a money-market or liquid fund. Choose the fund and start saving under the growth option through SIP. Ideally, keep the portfolio tilted towards debt, as equities usually perform well over the long term, but is considered a risky asset class in the short term. There are balanced funds to suit this situation. Balanced or hybrid funds, as the name suggests, allocate assets in their portfolio to both equity and debt. The equity component provides the power of returns, while debt provides stability against stockmarket volatility. Such funds will not rise as much as a pure equity fund, but will not fall as much either. If your goal is further away, you can consider taking higher risk and invest in diversified equity funds—choose large-caps and ensure you shift to less volatile debt funds at least two years before reaching your goal.

Choosing the right funds. A balanced fund plays the role of a joker that can complete any winning hand in a card game. It can be used for a host of investment functions—asset

allocation and diversification, portfolio rebalancing and for earning equity-linked returns with lower volatility than pure equity funds. A portfolio diversified across various asset classes shows greater stability in returns than one that invests only in one asset class. This is so because none of the asset classes consistently performs well over all time frames. So, a portfolio that is diversified between equity and debt will benefit from the performance of any of the asset classes in your portfolio. Technically, investment in a balanced fund allows one to hold a diversified portfolio. However, it is important to evaluate and track the performance of the funds and the fund manager should also take care to rebalance the fund allocation between equity and debt, as and when required. Investors, who do not want to take the pains of a fund's performance and manage portfolio allocation between asset classes, should invest only in balanced funds with suitable asset allocation, where the fund manager periodically rebalances the portfolio to the stated allocation.

MFs FOR CHILDREN'S FUTURE

When it comes to taking the MF route to planning for your children's future, you must follow the same basic principals as those for your own long-term financial planning. This goal is also long-term and equities give you the best option to reach your destination. And, again, if you do not have the expertise or the will to spend time tracking equity markets directly, take the MF route. Also, investment in MFs are one of the best regulated instruments in the stockmarket today, which do not require your day-to-day involvement.

Plan early. Like any other investment planning, the ideal time is to start early, i.e., as soon as your child is born. School fees may not be a big burden, but you will certainly have to save a substantial amount for his or her higher studies and wedding expenses. So, the sooner you start, the more time your savings will get to grow.

MFs FOR RETIREMENT

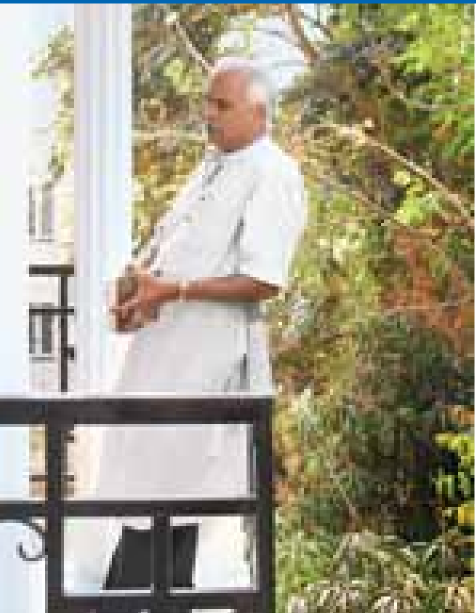
Retirement is one financial goal that largely takes a back seat for most of us, but those who pay attention to it early on in their life stand to gain. With life expectancy on the rise, the non-earning period in one's life is bound to put that much strain on your retirement years if you do not plan for it in advance. So, remember, the earlier you start, the lesser you will have to save regularly and equity MFs are just right vehicle for it to achieve your desired retirement corpus.

CHOOSING FUNDS AGE-WISE

The 20s investor. If you start investing as soon as you get your first job, it would certainly be easier for you because you will have fewer financial responsibilities and can afford to take risks. There is also an added advantage: you will be in a position to address any mid-course corrections to your portfolio without major hassles.

So, when you start out and are game to take risks, your portfolio should be heavy on equity funds—around 80 per cent. But, if you believe in conservative investing, you can allocate 60 per cent to equity funds. As a new investor, start investing in exchange-traded funds (ETFs) and index funds. ETFs and index funds invest in the same stocks and in similar proportion as they lie in their benchmark indices—BSE Sensex or the NSE Nifty. They are passively managed with an aim to reflect stock-market returns.

Try large-cap equity funds, which invest in well-established, top-rung companies and are less volatile, because they are actively managed and have the potential to beat the stock-market returns. Aggressive investors



can invest up to 30 per cent of their equity portfolio in mid-cap and small-cap funds.

The 30s investor. As you move up the ladder—you might have more or less settled down in life with a higher pay package, but also with more dependants: especially if you are married and have children, and, perhaps, parents to support—your financial responsibilities will also increase, and to cater to those needs while keeping your capital safe you need to move towards safer assets, such as debt and reduce your dependence on equity.

At the same time, you need to invest for your long-term goals, such as a house, funding your children's education and your own retirement needs.

Lessen your dependence on equity down to 70 per cent if you are an aggressive investor and 40 per cent if you are conservative. Conservative investors should stick with diversified equity funds; and the ones with more risk appetite must consider mid-cap, small-cap and sectoral funds to get better returns on their overall portfolio.

In your 30s, or even later, as you scale down your equity exposure, you should review your outlook on debt funds—they must now be seen as growth vehicles. Now, all your incremental debt fund allocation should flow into income funds.

The 40s investor. Your expenses tend to peak at this stage of your life. You may still be having some medium-term goals to provide for (a house or your children's higher education), and, at the same time, you would also have to proactively plan for your retirement. Therefore, you need to contain risk and, while doing so, ensure your retirement corpus grows substantially to with inflation-beating returns. To negotiate this tightrope, the aggressive investor should go with a perfectly balanced exposure to debt and equity. However, if you are risk averse, allocate 10-20 per cent more in debt. Irrespective of what your risk appetite is, this is the time to scale down your equity exposure and explore debt instruments that would provide stability of returns, such as floating-rate funds and fixed-maturity plans.

The 50s investor. By now, you have either met most of your big-money financial goals or are on the verge to

close on them, save your retirement. Whatever the case may be, this is the time to give top priority to secure your retirement by ensuring the safety of your capital and wait for the right time to migrate your money from riskier equity to safer debt instruments. How much you want to move will depend on your risk orientation as well as whether you are planning for a second career in retirement. If you expect to keep earning, you may risk a higher equity exposure. If you intend to live off your investments, increase your allocation to debt instruments.

Remember, debt MF schemes offer some advantage over other fixed income instruments. If you opt for dividend, it is tax-free, however, if you opt for growth option you will have to pay short-term capital gain (STCG) tax or long-term capital gain (LTCG) tax if you sells the units before a year or after a year, respectively. STCG tax is calculated as per your tax slab and the LTCG tax is calculated at 10.30 per cent without indexation, or 20.60 per cent with indexation.

MANAGING THE PORTFOLIO

Monitor your portfolio regularly and track the performance of the MF schemes you have invested in. Track your scheme's NAV every six or 12 month a and look for changes in the portfolio. Compare the scheme's performance with that of the Sensex, or its peers.

If your schemes have not done well for a over year or two, find out whether it is because of a depressed capital market or due to reasons specific to your scheme's performance. Don't get hassled if your scheme underperforms in a runaway market. But, if it is underperforming in a falling market (the fall in the scheme's NAV is greater than the fall in the benchmark index), review your investment.

You must read the fund manager's comments in the newsletters and the annual report. Ensure the fund is adhering to the objectives stated in the scheme information document. Also, keep track of various periodic statements, such as newsletters, half-yearly and annual reports.