

Quadrant II – Notes

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Unit 2 – Mutual Fund Products

Module Name: Concept of Entry and Exit load; Expense Ratio; Portfolio turnover; AUM

Module No: 06

Entry Load

Entry and exit-load are one of the integral charges linked with MF investments. Several administrative, operative, distribution expenses in addition to the costs pertaining to issuance of mutual funds are incurred by mutual fund organizations that is in general passed on to investors in the form of loads. Simply stated, it is the commission charged for investing in mutual fund scheme by Asset Management companies (AMCs).

Different schemes have different entry load charge percentages. Therefore, if you have reserved an amount of INR 10,000 to invest in a program with an entry charge of 5%, your investment amount will be reduced to INR 9,500.

After August 1, 2009, the Securities and Exchange Board of India (SEBI) implemented a no entry fee rule on mutual funds. This means that your entire amount will be invested without any deduction.

However, there may be separate fees or commissions charged by distributors, which may differ from plan to plan. Entry Load is a percentage of fee levied on the purchase of a mutual fund scheme. The levying of entry load reduces the investors' investment. For instance, a mutual fund scheme with 5% entry-load would deduct

entry-load from the amount invested into the scheme and invest the remaining amount.

Exit Load

Exit load is levied as a percentage amount when the investor wishes to exits or redeem one's mutual fund investments before the otherwise stipulated period. Thus, while an exit is made by the investor from a mutual fund scheme, the return that accrues on account of the investment made gets reduced as the percentage of exit load is reduced from the NAV.

Further, the percentage of exit-load varies from scheme to schemes. This exit load is indeed retained by the asset management company and does not form the part of the corpus of the scheme. There is yet another type of exit load referred as Contingent Deferred Sales Charge (CDSC). The levy of CDSC commands the investors to pay varying exit loads with respect to the investment term. If the investor remains invested in the mutual fund scheme for a relatively-long term, the % of exit-load charged is reduced. However, if the investor wishes to make an early exit from the investment, one has to part with huge amount as exit-load charges. Also, for investor's know-how, there are certain mutual funds that do not charge sales load. Such funds are therefore referred as no-load funds

Expense Ratio

Annual fund operating expenses, mostly known as the expense ratio, is the percentage of assets payable to the fund manager (i.e. AMC) as the maintenance fee.

The asset manager, with the help of a team of analysts and other experts, allocate, manage (including the auditor and advisor fees) and advertise the fund to maximize returns and manage risks.

If the funds' assets are small, then the expense ratio can be high. This is because the fund has to meet its expenses from a restricted or a smaller asset base.

Similarly, if the net assets of the fund are significant, then the expense percentage should ideally come down.

On 18 September 2018, SEBI brought about significant modifications by reducing TER of the mutual funds and changing the method of providing a commission to the distributors.

The expense ratio includes numerous charges for running the mutual fund plan. They recover this cost from the mutual fund investors on a day-to-day basis.

However, they disclose it to the investors once in every six months. Also, this will have a substantial impact on your take-home returns.

There are three significant components of expense ratio:

There are three major types of expenses as a part of the Expense Ratio.

a. Management Fees

Mutual funds require the formulation of investment strategies before actually investing money in the underlying assets. Fund managers need to possess a high level of educational, relevant fund management experience, and professional credentials.

The management fee or investment advisory fee is the compensation for the manager's expertise. On average, this annual fee is about 0.50% to 1% of the funds' assets.

b. Administrative Costs

The administrative costs are the expenses of running the fund. This would include keeping records, customer support, and service, information emails, and any other way of communication. This can vary greatly and are expressed as a percentage of fund assets.

c. 12-1b Distribution Fees

Many mutual funds collect the 12-1b distribution fee for advertising and promotional purposes. Usually, they charge their shareholders to market and promote the fund to the investors.

These three fees combined are equal to the percentage of assets deducted from the fund.

Portfolio Turnover

Portfolio turnover is a measure of how frequently assets within a fund are bought and sold by the managers. Portfolio turnover is calculated by taking either the total amount of new securities purchased or the number of securities sold (whichever is less) over a particular period, divided by the total net asset value (NAV) of the fund. The measurement is usually reported for a 12-month time period.

The portfolio turnover percentage can be used to determine the extent to which a mutual fund turns over its stocks and assets during the course of a year. The turnover rate represents the percentage of the mutual fund's holdings that changed over the past year. A mutual fund with a high turnover rate increases its costs to its investors. The cost for the turnover is taken from the asset's funds, as opposed to the management fee. Thus, mutual fund managers may not have very much incentive to reduce unnecessary trading activity.

The portfolio turnover is determined by taking the fund's acquisitions or dispositions, whichever number is greater, and dividing it by the average monthly assets of the fund for the year. For example, a fund with a 25% turnover rate holds stocks for four years on average. The higher the turnover rate, the greater the turnover. Higher turnover rates mean increased fund expenses, which can reduce the fund's overall performance. Higher turnover rates can also have negative tax consequences. Funds with higher turnover rates are more likely to incur capital gains taxes, which are then distributed to investors. Investors may have to pay taxes on those capital gains.

Certain types of mutual funds generally have higher turnover rates. Growth funds and funds with more aggressive strategies have higher turnovers. More value-oriented funds tend to have lower turnover. If the fund's performance is greater than a fund with a lower turnover, the higher rate may be justified. If the turnover rate is high, while the performance is lagging, an investor may be better off looking for alternatives.

AUM

AUM or Assets Under Management refers to the total market value of the assets that are being managed by the mutual fund. Simply put, assets under management or fund size are the overall value of the capital held by the mutual fund in the current market. These underlying assets are managed by an expert called Fund Manager who takes all important decisions regarding the mutual fund on investor's behalf.

AUM is highly useful when you want to have insights into the fund house and its success. How a fund house has performed as compared to its competitors is also reflected by the size of funds or Assets Under Management. Investors can also get insights into the returns earned by mutual funds by understanding the AUM of a mutual fund. These earning can be utilized in three ways-

- *Distributing investors as a dividend*

- Reinvesting in securities for further earnings
- Holding as per investment mandate

Assets under management are the overall market value of assets/capital that a mutual fund holds. The fund manager manages these assets and makes all investment-related decisions on behalf of the investors. AUM is an indicator of the size and success of a given fund house.

You can easily compare a fund's assets under management in various timelines and performance with other similar schemes. The AUM-value also includes the returns that a mutual fund earns. The asset manager can invest this in securities, distribute to investors as dividends, or hold as per the investment mandate.

Should you consider Assets Under Management while investing in mutual funds? This decision depends upon the type and size of the fund you are investing in- Equity funds, Debt funds, Small cap funds, Large cap funds

a. Equity funds

Here, consistency in returns and compliance of the fund house with the investment mandate matters more than AUM. By consistency, we mean beating the benchmark throughout the market highs and lows. Hence, an equity fund runs on the asset manager's skill to generate good returns consistently rather than popularity or size.

b. Debt funds

AUM is a crucial factor to consider if you are planning to invest in debt funds. A debt fund with more capital under it can spread the fixed fund expenses across the number of investors. This can reduce the expense ratio per person and hence increase the fund returns. More assets under the fund also help the fund company to negotiate reasonable rates with debt issuers.

c. Small-cap funds

Small-cap funds tend to restrict cash influx after a certain point. DSP BlackRock Micro Cap Fund is a widely known example for this. This usually occurs when the assets under mutual fund grow beyond a point. If the fund becomes a significant shareholder in a company, it may not be able to trade its shares easily when the market fluctuates. This is why a small-cap fund often avoids lump sum investments and stick to SIPs.

d. Large-cap funds

Let us dissect how AUM impacts large-cap mutual funds through an example. Mirae Asset India Opportunities and HDFC Top 200 are two large-cap equity funds. The former has an AUM of just Rs.4,738 crore, while the latter's is Rs.14,655 crore. Most investors may choose to invest in HDFC Top 200 for this reason. However, the Mirae has historically earned higher returns over various periods as the table below shows