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Advantages and disadvantage of Mutual Funds: A Review

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Abstract

Mutual funds may invest in many kinds of securities. Types of securities that a particular fund could invest in are set forth in fund's prospectus, a legal document that describes fund's investment objective, investment approach & permitted investments. Investment objective describes type of income/earnings that fund seeks. Eg. Capital appreciation fund generally looks to earn most of its returns from increases in prices of securities this holds, rather than from dividend or interest income. Investment approach describes criteria that fund manager uses to select investments for fund. A mutual fund's investment portfolio is continually monitored by fund's portfolio manager or managers.

Key word: Mutual funds, income, Investment, dividend, securities etc.

Introduction

The financial sector reforms, role of regulatory authorities and increase in savings attracted investors towards mutual funds. Stock market developments created popularity for equity oriented schemes. In the face of availability of multitudinous schemes, growth schemes introduced in the year 1993 has been studied. Sharpe, Treynor, Jensen and Fama's measures reveals that all the seven schemes showed negative risk premium, scheme's performance was in line with that of market performance, existence of a high degree of positive correlation in weekly time lag while the impact gets reduced as the time lag increases.

Advantages of Mutual Funds

Mutual funds have advantages about investing directly in individual securities are as follow:

1 **Increased diversification**: A fund normally holds many securities, diversification decreases risk.

2 **Daily liquidity:** Shareholders of open-end funds & unit investment trusts may sell their holdings back to fund at close of every trading day at a price equal to closing net asset value of fund's holdings.

3 **Professional investment management:** Open-end & closed-end funds hire portfolio managers to supervise fund's investments.

4 **Ability to participate in investments** that could be available to huge investors. Let's take example, single person investors sometime find this difficult to invest directly in other country markets.

5 **Service & convenience:** Funds often provide services such as check writing.

6 **Government oversight:** Mutual funds are regulated by SEC

7 **Ease of comparison:** All mutual funds are required to report same information to investors that makes them easy to compare.

Disadvantages of Mutual Funds

There are many advantages to investing in mutual fund but one should also be take precaution to check limitations of mutual funds.

1. **No Insurance**: Mutual funds are regulated by government but not insured against losses. Federal Deposit Insurance Corporation (FDIC) only insures against certain losses at banks, savings & loans, not mutual funds, credit unions. It means that despite risk-reduction diversification benefits granted by mutual funds, losses could occur, & this is possible that you may even lose whole investment.
2. **Dilution**: Diversification decreases risk of involved in investing in mutual funds, on other hand this should be a cons due to fact of dilution. For example, if a single security held by a mutual fund doubles in value, mutual fund themself shouldn't double in value because security amount is very small piece of fund's holdings. Mutual funds tend to do neither good nor bad by holding a huge number of investments.
3. **Fees & Expenses**: Most mutual funds charge management & operating fees that pay for fund's management expenses around 1.0 percent to 1.5 percent per year for working on fund to actively managed. Additionally many mutual funds charge high sales incentive, 12b-1 fees, & redemption fees. & some funds buy

& trade shares so often that transaction charges add up. Unlike stock investments several of expenses could be charged on routine base for that an incentive is paid only when you buy & sell.

4. **Poor Performance**: There should be no guaranteed on mutual fund returns. In fact, on average, around 75 percent of mutual funds are not able to beat big market indexes, like S&P 500, & a growing number of critic's queries whether or not a money managers have better stock-picking capabilities than average investor.
5. **Loss of Control**: Management team i.e. managers of mutual funds takes all decisions about securities to buy & sell & when to do so. This may make this tedious task for one when one should trying to manage one's portfolio. Eg. Tax magnitudes/scale of a conclusion by manager to buy or sell an asset at a certain time should not be good for any person.
6. **Trading Limitations**: Mutual funds are highly liquid & most mutual funds are also known as open-ended funds. Buying or selling can't be done in middle of trading day. You may only buy & sell them at end of day, after they've calculated current value of their holdings.
7. **Size of mutual fund**: Some mutual funds are huge to find enough good investments. This could be true most of time regarding funds whose targets are small business companies, given that there are strict rules about how much fund of a single company may own.
8. **Inefficiency of Cash Reserves**: Mutual funds generally maintain large cash reserves as protection against a large number of withdrawals. This provides investors with liquidity, this means that some of fund's money is invested in cash instead of assets, that tends to lower investor's potential return.
9. **Too Many Choices**: advantages & disadvantages listed above apply to mutual funds in general. There are about 10,000 mutual funds in operation, & these funds vary greatly according to investment objective, size, strategy, & style. Mutual funds are available for each investment strategy, each sector, & each country or region of world. So even process of selecting a fund may be tedious.

Structure of Mutual Fund

Mutual funds are not taxed on their income/earnings & profits.

1 They must diversify their investments.

2 Restrict ownership of voting securities.

3 Distribute most of their income/earnings to their investors annually.

4 Earn most of income/earnings by investing in securities & currencies.

There is an exception that net losses incurred by a mutual fund are generally not distributed to fund investors but are retained by fund to be able to offset future gains. Characterization of a fund's income/earnings is unchanged when this is paid to shareholders.

For example, when a mutual fund distributes dividend income/earnings to its shareholders, fund investors will report distribution as dividend income/earnings on their tax return. So mutual funds are called pass-through vehicles, as they simply pass on income/earnings & related tax liabilities to their investors.

Mutual funds in India

First mutual fund in India are introduced in 1963, when Government of India launched UTI (Unit Trust of India). Before 1987, Unit Trust of India enjoyed a monopoly in Indian mutual fund market. Then a host of other government organized Indian financial enterprises came up with their own funds. These consists of State Bank of India, Canara Bank, & Punjab National Bank. Such market was made open to private players in 1993 as a result of historic constitutional amendments conveyed onward by Congress government under existing regime of Privatization, Liberalization & Globalization. Kothari Pioneer was a first private sector fund to operate in India, after some time this will be merged with Franklin Templeton.

In 1996, SEBI, regulator of mutual funds in India, formulated Mutual Fund Regulation that is a comprehensive regulatory framework from MFs could take two form:

1 Dividends

2 Capital gains.

Types of mutual funds

There are three principal types of mutual funds in United States:

1 Open-end funds

2 Unit investment trusts (UITs)

3 Closed-end funds

- **Open-end funds**

Open end mutual funds should be ready to buy back their funds shares from their investors at end of every business day at net asset value (NAV) computed that day. Most open-end funds also sell shares to public every day. Such shares are priced at NAV. A professional investment manager oversees portfolio, buying & selling securities as appropriate. total investment in fund will vary based on share purchases, share redemptions & fluctuation in market valuation. There is no legal limit on number of shares that may be issued.

Open-end funds are most common type of mutual fund. At end of 2014, there were 7,923 open-end mutual funds in United States with combined assets of $15.9 trillion.

- **Closed-end funds**

Closed-end funds generally issue shares to public only once, when they are created through an initial public offering. Shares are then listed for trading on a stock exchange. Stockholders who no longer want to invest in fund can't sell their shares back to fund. Instead, they must sell their shares to another investor in market; price they receive may be significantly dissimilar from NAV. It should be at a superior to NAV (for example higher than NAV) or, more commonly, at a discount to NAV (for example lower than NAV). A professional investment manager oversees portfolio, buying & selling securities as appropriate.

At end of 2014, there were 568 closed-end funds in United States with combined assets of $289 billion.

- **Unit investment trusts**

Unit investment trusts (UITs) may only issue to public once, when they are created. Unit investment trusts generally have a limited life span, established at creation. Investors may redeem shares directly with fund at any time (i.e. open-end fund) or you may wait to redeem them upon trust's termination. Less commonly, they may sell their shares in open market. Unit investment trusts do not have a investment manager. Their portfolio of havens is recognized at UIT formation & does not change. At end of 2014, there were 5,381 UITs in United States with combined assets of $101 billion.

Conclusion

A mutual fund is known as investment fund managed professionally. It pools money from various investors in order to buy securities. While there is no legal definition of term mutual fund, this is generally applied only to those collective investment vehicles that are regulated & sold to public. This could be many times stated to as investment enterprises. Such enterprises are also known as registered investment companies.

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