

Study notes: Mutual Funds for Beginners

LEARNING OBJECTIVES

- Explain how a mutual fund is structured and regulated by SEBI
- Calculate and interpret NAV
- Compare SEBI fund categories and their risk
- Understand plans, options and costs (expense ratio, exit load)
- Read risk and return measures such as CAGR, XIRR and the riskometer
- Use SIP, STP and SWP sensibly
- Know how mutual fund gains and dividends are taxed

WHAT A MUTUAL FUND IS AND HOW IT IS STRUCTURED

A mutual fund pools money from many investors and invests it in shares, bonds, money market instruments or other assets according to a stated objective. Each investor owns units in proportion to their investment.

Structure in India (SEBI (Mutual Funds) Regulations, 1996)

Entity	Role
Sponsor	Sets up the mutual fund (like a promoter)
Trust and trustees	Hold the fund's assets for investors and supervise the AMC
Asset Management Company (AMC)	Manages the money: research, buying and selling securities
Custodian	Safely holds the securities
Registrar and Transfer Agent (RTA)	Maintains investor records and processes transactions

Every mutual fund and its schemes must be registered with SEBI. Investor money is held in the trust, separate from the AMC's own money.

Why invest through a mutual fund? Diversification with a small amount, professional management, liquidity (most open-ended schemes can be redeemed on any business day), transparency (daily NAV, monthly portfolios) and regulation.

NAV AND HOW UNITS ARE PRICED

Net Asset Value (NAV) per unit = $(\text{Market value of investments} + \text{Cash and receivables} - \text{Liabilities and expenses}) / \text{Units outstanding}$

Example: a scheme holds investments worth Rs 101 crore and cash of Rs 1 crore, with liabilities of Rs 2 crore. Units outstanding: 5 crore.

$$\text{NAV} = (101 + 1 - 2) / 5 = \text{Rs } 20 \text{ per unit.}$$

If you invest Rs 10,000 at NAV Rs 20, you get 500 units (before stamp duty). If the NAV later rises to Rs 25, your investment is worth Rs 12,500.

Key points

- NAV is declared every business day.
- A low NAV does not make a fund "cheaper". What matters is the percentage change in NAV.
- Cut-off times decide which day's NAV applies. For most purchases, units are allotted at the NAV of the day on which the money is available to the fund before the cut-off time.
- Stamp duty of 0.005% applies on purchases of units.

SEBI FUND CATEGORIES

SEBI's categorisation framework makes schemes comparable. Each fund house can generally offer only one scheme per category.

Equity schemes (high risk, long-term growth)

Category	What it holds
Large cap	Mainly the top 100 companies by market value
Mid cap	Mainly companies ranked 101-250

Small cap | Mainly companies ranked 251 and below
Flexi cap / Multi cap | Across sizes (multi cap has minimum allocations to each)
ELSS | Equity with a 3-year lock-in; deduction under the old tax regime
Sectoral / thematic | One sector or theme; concentrated risk
Index funds and ETFs | Track an index passively at low cost

Debt schemes (lower volatility, but interest-rate and credit risk)

Category | What it holds
Overnight | Securities maturing in 1 day
Liquid | Securities up to 91 days
Short duration, corporate bond, banking and PSU | Longer maturities, varying credit quality
Gilt | Government securities (no credit risk, interest-rate risk)
Credit risk | Lower-rated bonds for higher yield; higher risk

Hybrid schemes: aggressive hybrid (65-80% equity), balanced advantage (dynamic equity allocation), arbitrage (low-risk equity arbitrage) and others. Solution-oriented schemes (retirement, children's) have lock-ins. Fund of funds invest in other funds.

PLANS AND OPTIONS: DIRECT, REGULAR, GROWTH AND IDCW

Every scheme has two plans:

| Direct plan | Regular plan
How you invest | Directly with the AMC or through an RTA or platform | Through a distributor
Expense ratio | Lower | Higher (includes distributor commission)
NAV | Higher over time | Lower over time
Suits | Investors who choose and review funds themselves | Investors who want ongoing help from a distributor

Options

- Growth: gains stay invested and the NAV grows. Usually better for long-term wealth.
- IDCW (Income Distribution cum Capital Withdrawal): the fund pays out part of the NAV. The payout comes from your own capital or gains, so the NAV falls by the amount paid, and IDCW is taxable at your slab rate.

Example: on a Rs 10 lakh portfolio, a 1% a year difference in expense ratio can reduce the corpus by several lakh rupees over 20 years, because costs compound.

COSTS: EXPENSE RATIO, EXIT LOAD AND OTHER CHARGES

Total Expense Ratio (TER): the annual cost charged to the scheme for management, administration and distribution, as a percentage of assets. It is deducted daily from the NAV, so you never pay it separately. SEBI caps TER in slabs based on the scheme's assets; equity schemes are allowed higher limits than debt schemes.

Exit load: a charge on early redemption, for example 1% if redeemed within 12 months. It discourages short-term trading and is deducted from the redemption value.

Other points

- There is no entry load on mutual funds.
- Stamp duty of 0.005% on purchases.
- Securities Transaction Tax (STT) applies on redemption of equity-oriented units.

Compare TER only within the same category; an index fund and an active small cap fund are not like for like. Check the latest TER on the AMC website or the AMFI website.

RISK AND RETURN: HOW TO READ THE NUMBERS

Riskometer: every scheme shows a risk level from Low to Very High (six levels). It is updated monthly based on the portfolio.

Return measures

Measure | What it tells you
Absolute return | Simple percentage gain, useful for under a year
CAGR | Average annual growth for a lump sum: $(\text{End value} / \text{Start value})^{(1/\text{years})} - 1$
XIRR | Annualised return for cash flows on different dates, such as SIPs

Rolling returns | Returns over many overlapping periods; shows consistency better than a single point

Risk measures

Measure | Meaning

Standard deviation | How much returns swing; higher means more volatile

Beta | Sensitivity to the market; beta 1.2 means the fund tends to move 20% more than the index

Sharpe ratio | Return earned per unit of risk above the risk-free rate; higher is better

Example: Rs 1,00,000 grows to Rs 1,76,234 in 5 years. $CAGR = (1.76234)^{(1/5)} - 1 = 12\%$.

Past returns do not predict future returns. Compare funds against their benchmark and category over at least 5 years.

SIP, STP AND SWP

SIP (Systematic Investment Plan): invest a fixed amount every month. You buy more units when prices are low and fewer when high (rupee cost averaging), and build discipline.

Rupee cost averaging example (Rs 10,000 a month):

Month	NAV (Rs)	Units bought
1	50	200.0
2	40	250.0
3	45	222.2
4	55	181.8
Total		854.0 units for Rs 40,000

Average cost per unit = $40,000 / 854 = \text{Rs } 46.84$, lower than the simple average NAV of Rs 47.50.

STP (Systematic Transfer Plan): move a lump sum gradually from a liquid or debt fund into an equity fund to reduce timing risk.

SWP (Systematic Withdrawal Plan): withdraw a fixed amount regularly, for example in retirement. Each withdrawal is a redemption and may attract capital gains tax.

Use ArthaKara's free SIP and Lumpsum calculators to estimate growth (estimates only, not guaranteed).

HOW MUTUAL FUNDS ARE TAXED

Tax depends on the type of fund, the holding period and the date of sale. For sales on or after 23 July 2024:

Fund type | Short-term | Long-term

Equity-oriented (at least 65% in Indian equity) | Held up to 12 months: 20% | Held over 12 months: 12.5% on gains above Rs 1.25 lakh a year

Debt and specified funds bought on or after 1 April 2023 | Always taxed at slab rates, regardless of holding period |

Other funds (for example certain FoFs, international funds) | Held up to 24 months: slab rates | Held over 24 months: 12.5% without indexation

IDCW (dividends): added to income and taxed at slab rates. The fund deducts TDS where IDCW exceeds the threshold in a year.

ELSS: investments qualify for deduction (up to Rs 1.5 lakh with other eligible items) only under the old tax regime.

From Tax Year 2026-27, these provisions continue under the Income-tax Act, 2025 with new section numbers. Use ArthaKara's Income Tax Calculator to include your gains.

CHOOSING, INVESTING AND REVIEWING

Before investing

1. Complete KYC (PAN, Aadhaar, address proof) once with any KRA.
2. Define the goal, amount and time horizon: emergency fund (liquid fund), 3-5 years (hybrid or short-duration debt), 7+ years (equity).
3. Match the fund's risk level to your risk tolerance.

4. Read the Scheme Information Document (SID) and Key Information Memorandum: objective, benchmark, fund manager, costs, exit load.

5. Add a nominee.

Choosing a fund: look at consistency of rolling returns against the benchmark, expense ratio, portfolio quality and the fund house's processes, not just last year's top performer.

Reviewing: check once or twice a year. Rebalance when your asset mix drifts far from the plan. Avoid reacting to short-term market falls.

Investor protection: complaints go first to the AMC, then to SEBI's SCORES portal. Check that a distributor holds a valid AMFI Registration Number (ARN).

FURTHER READING

SEBI (Mutual Funds) Regulations, 1996

SEBI circulars on categorisation and rationalisation of mutual fund schemes

Sections 2(42A), 50AA, 111A and 112A of the Income-tax Act, 1961 (corresponding provisions of the 2025 Act)

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