A BEGINNER'S GUIDE TO MUTUAL FUNDS

A UNOVEST GUIDE 2019

Introduction

There are more than 800 mutual fund schemes in India offered by 44 fund houses (as of Nov 2019). These fund schemes come in a wide variety of options, investment styles and investment objectives.

It's baffling.

How do you go about choosing the best ones for your portfolio that will help you meet your goals?

How do ensure that you don't make grave mistakes in your selection and rather pick schemes that will take care of your money as their own?

How do you choose those funds which do not take undue risk and yet generate an adequate inflation beating return to help you build your wealth to meet goals?

Given the wide choice, many well-meaning organisations and individuals have come up with ways to help you select the best mutual funds that channelise your savings, which can grow them at a reasonable risk.

This help comes in the form of ratings, rankings and opinions. Unfortunately, none of them makes your job to select mutual funds absolutely easy. At best, they act as first level filters. You still have to make choices from the reduced list of options.

What to do?

Which funds should you pick?

How do you build a decent portfolio that puts your money to work while you focus on what you are good at – your work and growing your income?

These are the questions that this eBook seeks to answer.

With this eBook, you will:

1. Understand how NOT to select a mutual fund
2. Learn to work with key factors to consider in mutual fund selection
3. List the criteria for your own fund selection
4. Build your own portfolio of equity mutual funds (by applying additional criteria)
5. Create an asset allocation with mutual funds
6. Avoid the key mistakes in building a mutual fund portfolio
7. Know when to sell a mutual fund (or book profits)

If you have any feedback or comment that you would like to share about this eBook, feel free to write to me at vipin@unovest.co.

All the best for building your own winning mutual fund portfolio!

Your friend @Unovest
Vipin Khandelwal

Disclaimer

All information in this eBook is for education and information purpose only. It is to help you become a better investor. The names of the funds mentioned in this eBook are used as examples for better understanding. None of the information in this document should be considered as an investment advice. Please read the terms of use of the Unovest website.

Insider Plus from Unovest

All our tools, advice, recommendations, support from our practice bundled here so that you can use them to build and monitor your financial plan, portfolio to reach your goals, faster.

Know more about Insider Plus.

Index

#1

How NOT to select a mutual fund?

While there is a ton of advice on how to select mutual funds and how to build a portfolio, there is very little on how NOT to.

So, let's invert the 'selection' process and understand how NOT to select mutual funds.

--

Finding a good mutual fund scheme relevant to your needs is like finding a needle in a haystack.

You start to apply various filters and shortcuts to find these needles in a haystack, to select mutual funds that you should invest in.

Due to lack of time, effort and inclination, you pick and choose your funds using easy, convenient and obvious indicators such as:

1. **Star Ratings** – Typically 4 to 5 star rated funds
2. **Past Returns** – Funds with higher 3 to 5 year returns should be better than the rest
3. **Brand** – a popular, well-known brand
4. **Friends, Colleagues, Popular media** – You feel you can trust them.

Let us understand each of them - one by one.

#1 Star Ratings

Star Ratings is an idea that we use in almost every aspect of our lives for evaluating hotels, restaurants, business services, websites, advisors, etc. Everything has a star rating.

The star ratings just make it easier for us to decide. I mean how else do you find out whether to put your money for that product/service or not. It is convenient to rely on existing user experiences, which reflect in the ratings.

Now, when it comes to mutual funds, you would prefer to invest in a 4 or 5 star rated fund. You believe it to be the best. Right?

Not really. **There is a big problem with star ratings of mutual funds.**

First, these star ratings do not reflect user experiences like they do for hotels or e-commerce sites. They are created based on a complex methodology using past returns and risk and is developed by the ranking / rating organisations.

Second, mutual funds are not able to maintain their ratings over time. If you track the ratings over 1 or 3 or 5 years of various mutual funds, you would see that the ratings change almost every year, sometimes every few months.

Since they are based on quantitative factors only such as risk and return, as the numbers change, the ratings change too. It is not be surprising to see a 5 star rated fund being down rated to 3 stars and vice versa.

If you go to any of the rating portals, like Value Research or Morning Star, you can track the ratings of the fund schemes and see how these ratings change for the funds that you are invested in or want to invest in.

You invest in a 5-star rated fund only to find that next year it has gone to 3 stars.

Let's see what it does to your investment.

When you select mutual funds and invest on the basis of star ratings, you would have to keep selling and buying mutual funds as and when the ratings change.

This means you have to incur taxes related to buying and selling. It also means that you need to invest time and effort to keep track of changes in ratings or pay fees to an advisor to do the same for you.

If you don't exit your lower star rated funds and just keep buying the new 5-stars, you are soon going to have an ugly, bloated portfolio with several schemes.

Investing on the basis of star ratings ONLY is definitely NOT a good idea. The pioneer of Mutual Funds rating company as also the biggest, Morning Star, says that too.

#2 Past Returns

What is the standard disclaimer you find on any mutual fund factsheet or advertisement?

> "*Past performance is no guarantee of future returns. Please read the offer documents carefully before investing.*"

This is not just a disclaimer. It is a fact. Yet, when we set out to buy mutual funds, the first thing (sometimes the only thing) that we look at is 'past returns'. I would argue that you should NEVER look ONLY at returns to select mutual funds.

In my humble opinion, an investment decision purely on the basis of returns is a big mistake.

You see, relying solely on performance can do more harm than good to your portfolio. You will churn your portfolio too much and it is quite likely that you will enter a high flying fund only after it has run out of steam.

You are probably aware about the law of mean reversion. Any period of superior performance is likely to be followed by a period of lower performance. Overall, over long period of time the returns tend to move towards the average or mean

Rather, you must focus on how the fund goes about managing the portfolio. You cannot control returns. At best, you can trust the process.

#3 Brand Name

A BRAND is a mental shortcut to familiarity and trust. It is not just true for mutual funds but almost anything. Ask any fresher MBA today about where she would want to work and the instant answer is "with a big brand".

Now, money is a very sensitive subject. You would not want to hand over your hard earned money in the custody of someone you cannot trust. A popular, well-known brand, thus, acts as an affirmation of the trust.

A good brand name, however, is no guarantee that it is good for your money too. Let me bring forth some facts.

A lot of existing fund houses in India have been working under the umbrella brands of their parent organisations and riding on the trust that the parent enjoys. Take for example, an HDFC, Tata, Aditya Birla, etc.

Yet, the brands have committed big mistakes.

They have launched multiple schemes to amass large funds, all in the name of customer interest. The larger the number of schemes, the messier it becomes for an investor to pick the relevant ones.

The idea is to constantly rotate you from one scheme to another using the past performance of the latest winner as the bait.

The bottom line is, a well-known brand is good but not necessarily for your portfolio too.

#4 Friends & family

A simple example will suffice here.

I remember a gentleman ran a poll on a popular Facebook forum, as to which top 2 or 3 equity mutual funds do the group members invest in? As the replies started to come in, you could find almost every mutual fund name out there.

As the popular Hindi saying goes, *jitney muh, utni baatein*.

Jitne log, utne fund schemes.

I rest my case.

You are better off ignoring the noise generated by the above parameters / filters and focus on what really matters.

Let's move to the next section.

#2

What to look for in a mutual fund scheme?

Let's now look at what truly matters in fund selection.

A mutual fund has several features and it is important to understand them to make a proper selection.

Understanding the details of a scheme enables you to take a perspective about that scheme and decide if it suits your goals.

Here is an overview of the key items that you need to understand about a mutual fund scheme.

For reference, we will use Franklin India Bluechip Fund (FIBF) and its factsheet for July 2017.

#1. Scheme Objective

This is a brief summary of what the scheme intends to do.

In case of FIBF it is "*is an open end growth scheme with an objective to primarily provide medium to long-term capital appreciation*."

Most scheme objectives tend to be vague and that's where you can spot the difference. A clearly defined investment objective is a good signal.

#2. Benchmark

The fund scheme benchmarks its performance against a market index. The choice of the index benchmark helps understand what kind of a stock selection strategy a scheme is likely to follow.

The benchmark for FIBF is **S&P BSE Sensex**. BSE Sensex consists of some of the largest companies as per market capitalisation in the Indian stock market. This further affirms the idea that the fund is likely to invest in large cap '**bluechip**' stocks.

#3. Fund Manager

While most fund houses profess to be governed by processes and not by individual whims, fund managers do tend to influence the investment style of a fund. It is not easy to discount the fund manager experience. It does matter.

A good fund manager helps create a strategy that can deliver better risk-adjusted returns for the fund scheme.

However, a fund that delivers only because of the presence of a particular fund manager is unlikely to sustain its performance in the long term.

FIBF's current fund managers are Anand Radhakrishnan (managing the fund since June 2013) and Roshi Jain.

#4. Investment Style

The investment style is a sneak peek into fund's investment universe and the process of stock selection.

It may also specify the maximum number of stock the fund will have in the portfolio and the allocation range for a stock. This defines the diversification strategy of the scheme.

FIBF investment style statement says, "*The fund manager seeks steady and consistent growth by focusing on well established, large size companies.*"

You can find more details about the investment style in the Scheme Information Document (SID).

#5. Portfolio holdings (stocks/sectors)

The current holdings of the fund in terms of stocks and sectors give you an idea of where the fund is invested and whether it is in line with the objective and style it has identified for itself.

You may see Top 10 stocks and sectors in some cases, while other fund factsheets present the entire portfolio.

FIBF has 43 stocks in its portfolio – which means that the portfolio is quite diversified indicating an average of about 2.5% per stock. However, 9 stocks in the portfolio have an allocation higher than the average.

#6. Turnover

The turnover of the portfolio suggests how often the fund makes changes to its portfolio in terms of buying and selling stocks/securities.

As a general rule, the lesser it is, the better. Higher turnover means more churning, more expenses, which can drag down returns.

FIBF's turnover, as per the July 2017 fact sheet is, 36.45%. That means that on an average an investment in a stock stays for about 3 years in the portfolio.

Remember this is standalone number as of July 2017. You need to understand the trend. For example, a few months ago, the fund had a turnover of just 17%. So, is this just one off number or the fund is using more churn in its portfolio?

#7. Past performance

For most investors, past performance is the holy grail of fund selection and that too point-to-point returns for lump sum investment amount. This is highly misleading.

They make their investment decisions based on this one factor. This may not be correct. At least, past performance and point-to-point returns is not the only thing that one should look at.

Rolling returns provide a much better idea of a fund performance since they look at performance across time periods more like a trend.

Along with it, portfolio strategy and various other ratios deserve more attention than just past performance.

Volatility and Risk adjusted return measures

These measures pertain to ratios such as Standard Deviation and Sharpe Ratio. These measures could again be different numbers depending upon where you are looking. Different time periods can produce different results.

In case of FIBF, data over a period of 3 years has been used for the calculation.

#8. Standard Deviation

Standard deviation tells you how much of a yo-yo the fund's value tends to be against its average. Higher the standard deviation, more volatile the fund is.

FIBF has a standard deviation of 3.66%, which means that it is less volatile.

#9. Sharpe Ratio

The Sharpe Ratio is a measure of how much additional return the fund has delivered for every additional unit of risk taken.

It is calculated as
= (% Return of the fund – % Risk free rate of return*) / Standard Deviation

In case of FIBF, the Sharpe Ratio is 0.61.
**Risk free rate is, for example, the 10 year Government Bond rate.*

Most of these ratios are better understood when compared with peers or over a time period as trends.

#10. Expense Ratio

The expense ratio is the fee charged for running the show. It is a sum of all expenses that the fund charges including Investment management fee (plus GST), sales and distribution costs including commissions, brokerages, custodian charges, etc.

In case of FIBF, it has an expense ratio of 2.23% for its regular plan while the expense ratio of direct plan is 1.36%.

Direct plan expenses are always lower because they do not have commission costs to pay.

--

As an investor, it is quite likely that you feel overwhelmed with this information. Anyone would be.

However, you can build a considerable advantage by learning to look at these parameters.

Start with the fund factsheet and then you can go deeper with the Scheme Information Document. Use it to ask more questions of a fund.

Know and understand your fund in advance before you make your investment. It will prevent a lot of heartburn later.

#3

Setting the portfolio selection criteria

Now that we understand what's important about a mutual fund and you have gone through a few fund factsheets, you may want to rush and pick funds for your portfolio.

That's what Ajay wanted to do too. I had to literally hold him by his hand.

"Not so fast! Wait!"

As you know, there are thousands of mutual fund schemes. Let's first identify what are the criteria that will work for you to shortlist schemes and to build your unique equity mutual fund portfolio.

Now, given the hundreds of schemes under consideration, we can use some simpler filters to remove most of them.

- **No Sectoral/Thematic funds**: As far as possible, stick with diversified funds which can invest across sectors and not restrict themselves to a particualr theme. Hence, skip the sectoral/thematic variety such as those focused on Pharma, Exports, Logistics, etc. There is no point restricting the scope of the fund in finding opportunities.

- **Index Funds:** Unless you are an investor who does NOT believe in active fund management, index funds are not for you. Fortunately or unfortunately, in India, the actively managed funds have still some way to go.

- **No Closed ended funds:** Closed ended funds are open only for a limited initial period for buying. You are locked in during your investment period and cannot make changes. Hence, they can be excluded too.

Now, let's list down what to pay attention to. On the specific fund scheme level, here are the things to be considered.

- **Fund age**: Typically, consider funds with more than 5 years of existence. However, entities that have a cumulative organisation experience of over 5 years in fund or investment management can also be shortlisted.

- **Fund Size**: A good criterion would be to have funds with at least Rs. 100 crore of AUM. However, we cannot let a good fund pass just for this one criterion.

- **Expense* Ratio**: Expense is the only thing that you can control. Aim to go for funds that are not very expensive but deliver the right value for what they charge. Even better way to look at this is to see the trend of the expense line. A good fund will work to reduce its expense ratio as it grows. Fund houses like Quantum, PPFAS, Franklin India etc. have shown this trend.

- **Turnover Ratio**: A consistently high turnover ratio is a red flag too. With equity funds, the turnover ratio should be not more than 30% to 40%.

*Direct plans also ensure that your expense ratio remains on the lower side. In debt funds, a higher expense ratio can wipe off any advantage that you came looking for.

As you would notice, **past performance is not one of the filters here.** You already know why.

Use these factors to download a filtered list of funds from one of the online aggregator sites or from Unovest.

The funds that we select should have a well defined investment mandate and a laser sharp execution focus. **Let's now go on to build an actual mutual fund portfolio.**

#4

Let’s build an actual mutual fund portfolio

When Ajay approached me for his mutual fund portfolio, he mentioned that he wants to invest for his retirement, which is about 20 years away.

He has a **moderate to aggressive** risk profile. At Unovest, a moderate risk taker is recommended to have upto 60% allocation to equity (via stocks or equity mutual funds). Ajay can afford to be 60%+ but then his asset allocation and his need will decide that.

The question on Ajay's mind is which schemes should he select towards his retirement.

He has gone through the previous notes on fund selection and agrees with the process.

He wants to include those funds which will deliver a better risk adjusted return over a long period of time.

After studying and applying the criteria discussed so far, he came up with his first shortlist.

Ajay's Shortlist of Mutual Funds

Scheme Name	Category
Quantum Long Term Equity Fund	Predominantly Large cap
HDFC Midcap Opportunities Funds	Mid cap
Franklin India Prima Plus Fund	Flexi cap
ICICI Pru Focused Bluechip Equity Fund	Large cap
Franklin India High Growth Companies Fur	Flexi cap
Mirae Asset India Opportunities Fund	Flexi cap
Mirae Asset Emerging Bluechip Fund	Mid cap
ICICI Pru Value Discovery Fund	Flexi cap
Parag Parikh Long Term Value Fund	Flexi cap
Sundaram Select Midcap Fund	Mid cap
SBI Bluechip Fund	Predominantly Large cap
Aditya Birla Sunlife Frontline Equity Fund	Predominantly Large cap
HDFC Top 200 Fund	Predominantly Large cap
HDFC Equity Fund	Flexi cap
IDFC Premier Equity Fund	Flexi cap
Franklin Build India Fund	Flexi cap
MOST Focused Multicap 35 Fund	Flexi cap
Franklin India Smaller Companies Fund	Small cap
L&T India Value Fund	Flexi cap

This is quite a huge list of funds, close to 20.

Ajay realises that while most of these funds are great performers with brilliant history of management, he can't have all of them. He needs only 4 to 5 funds to build a diversified portfolio for his retirement.

The question now is which of the above should be included and which ones to be excluded?

It's a difficult choice. The funds have differentiated strategies which they have been executing on relentlessly.

So, Ajay lists a few **additional guidelines** towards limiting his choices and building a portfolio. They are:

1. **No more than 5 funds in the portfolio and give them adequate weightage to be able to move the needle and make a difference.**

2. **Preference for flexicap/multicap funds** since they can move around the entire spectrum of capitalisation and not be limited to large cap, mid caps or small caps. Predominantly large cap funds can be considered.

3. **No pure large cap funds**, since most flexicap / multicap funds already have a significant portion in large cap stocks.

4. **More of mid and small cap funds** to add that extra risk element. A good fund with a focused mandate in that space can boost the overall portfolio returns.

5. Focus on the cost element that is **expense ratio**. He would prefer funds which have a history of reducing their expenses as AUMs grow.

6. Focus on "buy and hold" funds. This can be measured by a low **turnover ratio** – typically not more than 40% and should be reflected in the trend.

The above itself will not be sufficient to bring down the list number to 4 or 5. Hence, Ajay has decided to apply one more criteria.

> **The AMC should have a clear focus on fund management and be a standalone professional fund house with 'skin in the game'.**

The Skin in the game means that the fund managers should have invested their own money into the funds. It is a simple heurestic – **does the cook eat his own cooking?**

Finally, Ajay had a portfolio that catered to his own criteria and requirements.

How can this portfolio turn out to be different for someone else?

Let's build a different portfolio, for you.

Suppose you are willing to take a much more aggressive approach towards your portfolio. You want to include more mid caps as well as run a concentrated portfolio with fewer holdings.

In that case, from Ajay's shortlist, your portfolio could include funds such as:

1. Motilal Oswal Multicap 35 Fund
2. Parag Parikh Long Term Equity Fund
3. Sundaram Midcap Fund
4. DSP Small Cap Fund

Remember – to each, his own.

That's what a customised portfolio relevant to your needs, risk appetite and time horizon is about.

So, what will your portfolio look like?

#5

Asset allocation with mutual funds

Asset Allocation is one of the finest diversification mechanisms. It is the method to how should you divide your money between various asset categories or classes such as equity, bonds, real estate, gold and cash.

Your financial goals, time horizon and risk tolerance play a role in deciding this allocation.

For example, after considering all the factors mentioned, suppose you decide to have the following asset allocation for your portfolio:

Asset	Allocation
Equity	50%
Bonds	20%
Real Estate	25%
Gold	5%

What if I tell you that there is a mutual fund for all of these options.

Imagine the range, convenience and flexibility of mutual funds to execute your own portfolio asset allocation.

For **Equity**, you can choose equity mutual funds as the investment vehicle.

For **Bonds**, in India there are many options that investors exercise, including EPF, PPF, Corporate Deposits, Postal Schemes, Fixed Deposits, etc.

Debt mutual funds too can be used to make any required allocation towards bonds. Debt funds or Bond funds are also more tax efficient, specially for high tax bracket individuals.

Real Estate can be allocated with REITs or Real Estate Investment Trusts. We have just seen one REIT launched in India and hopefully there shall be more.

Gold Mutual Funds which invest in actual physical gold such as Gold ETFs and Gold Saving Funds can be used to allocate towards Gold.

With mutual funds, you can own Gold and Real Estate without the pains and the costs of holding a physical asset.

Rebalancing the asset allocation becomes a fairly simple exercise too.

If you have to sell a part of the Real Estate to invest in bonds/equity, you can always sell a portion of the REIT to get your asset allocation in order.

#6

How to select Debt mutual funds

Any Asset Allocation is incomplete without fixed income instruments and one of the ways to get that is debt mutual funds.

Debt funds can play an important role in investment portfolios, given the liquidity and tax efficiency they bring to the table.

Let's spend some more time on **how to select debt mutual funds for your portfolio**.

How to select Debt Mutual Funds

Selecting debt mutual funds is tougher than selecting equity funds. This statement may be difficult to believe, but true it is.

The variety and the individual investment styles varying through credit quality and time horizon is so large in debt funds, that you can easily get lost.

To first understand debt funds, you need to know that debt funds invest privately with corporates (they loan money to these corporates for a return), and also invest in government securities.

There are **2 key risk parameters**.

One, the credit quality or how likely is the borrowing party likely to honour its payment and not default. Government securities are assumed to be the highest quality as the chances of default are nil.

Two, what is the time horizon for which the investment is being made? With longer duration, more market risk enters the portfolio. *Debt funds are sensitive to change in interest rates and this sensitivity goes up as the duration goes up.*

Having taken these into account, we can rely on a few filters to identify the right funds for our portfolio.

Here is what I use to shortlist the debt funds:

1. **Age:** Consider schemes that have been in existence for at least 3 years.

2. **Size**: Schemes should have more than Rs. 100 crores of Asset under Management.

3. **Cost** is an important factor when it comes to debt funds. If you have to choose between two similar funds, choose the one with the lower cost. Also, choose direct plans. *I observed that the expense ratios of direct plans were almost half of those of the regular plans (on account of savings in commissions).*

4. **Credit Profile**: Debt funds invest in credit instruments of other companies and/or the government. To maintain the risk profile, the credit quality of the portfolio is important too. Hence, funds with High and Medium Credit quality holdings have been included in the list. This credit quality is typically measured with the credit rating such as AAA, AA, A+, BB, BB-, etc. (*Recent episodes with debt funds have brought forth the risks associated and the fact that no mutual fund house is immune to these risks*.)

5. **Sensitivity to interest rates**: Finally, pay attention to Duration (measure of the *sensitivity of the portfolio to change in interest rates*) and Average Maturity of the fund portfolio. A *thumb rule* is that you should choose a fund that has a Duration less than your investment time horizon.

Most of the above information is available in factsheets as well as online portals.

Along with that background, you can rely on the following SEBI defined categories to make your final selection.

- **Liquid funds** – For very short term periods say, 3 to 6 months, even 1 year for that matter. The focus has to be on safety of capital than earning a higher return. **Examples** are

Quantum Liquid Fund or Parag Parikh Liquid Fund, which invest only in Govt Securities.

- **Ultra-Short term / Low Duration funds** –
  For time horizon of 6 months to 1 may be 2 years. The portfolio duration for this category is slightly higher than liquid funds.

- **Short term funds** – For time horizon of 2 to 3 years or more. It is important to stick to good credit profile here.

- **Corporate Bond Funds / BFSI focused funds** – For a period of 2 years plus, these funds can be considered for growth as well as income.

The liquid, ultra short term and some short term funds follow an accrual strategy where the focus is to work with cash flows generated by their holdings.

The duration funds or medium and long term funds tend to play on the interest rate scenario and positioning their portfolios accordingly. This strategy focuses on generating capital gains by active management of the portfolio. This can add volatility and risk.

When choosing debt funds, remember, chasing yields or high returns will, more often than not, only get you into trouble. 2018 – 19 has proven that big time.
Just because a credit risk fund is available, doesn't mean you have to sacrifice your money to its adventures.

It is better to focus on good credit quality, large size portfolios, your personal time and the fact if the scheme under assessment has a consistent history of making bad decisions.

I repeat – **Don't chase high yields.**

#7

Profit booking in mutual funds – Wise or Foolish?

"*I am thinking of booking profits in my mutual fund portfolio"*, Vivek mentioned casually. I looked up and asked him, "*OK. Why do you want to do that?*"

"*You see the markets have run up so high and the value of my funds has also gone up by about 30% to 40%. I should book the profits before I lose them all to a market fall.*"

I smiled at my friend's rhyming logic of profit booking. Now, he was right in one sense but completely wrong in another. How?

Let's understand it step by step.

What is profit booking?

Profit booking simply means that you convert your unrealised paper profits into cash. Without this conversion, the gains or the profits don't mean anything.

For example, 1 year ago you bought stock of Company A at Rs. 100. Now the current market price of the stock is at Rs. 150. The stock has delivered a 50% profit but for you it is only on paper. You will actually own the profit only when you sell the stock and realise Rs. 50 of profit in cash.

Profit booking is an important step in investment management but it has to be done for the right reasons.

When should you book profits?

Should it be when the markets have run up a lot?

Should it be when the TV experts are shouting at the top of their voice - sell, sell?

Should it be when the fund has lost steam and has changed fundamentally, hence not in alignment with your filters?

Should it be when you need the money for the downpayment of your house?

When it comes to stocks, it has been famously said that the *best time to sell a good quality business bought for a decent price* is NEVER.

Having said that, you can book profits or sell your stocks for one of the following reasons:

#1 You believe that the stock that you bought has gone beyond its real value (or intrinsic value). It is best to book profits now and may be reinvest in that stock later.

#2 You find a better business, the stock of which is far more attractive and you would like to shift your investment.

#3 You simply feel that based on your new analysis of the business, it is not as attractive as it originally appeared to be and it is best to exit or cut down allocation.

#4 You need the money for a real cash flow need such as a medical emergency, paying for your child's higher education or may be to make a downpayment for your house.

Profit booking in mutual funds?

Now let's talk about the original question of profit booking in mutual funds. It will be important here to revisit the core idea of investing through a mutual fund.

> A mutual fund allows you to own a portfolio of stocks, bonds or commodities. Like you, several other investors also invest

in the same fund. The investment decisions on which stocks to buy or sell are done by a team of fund managers and research analysts.

Based on various criteria including the investment mandate and the strategy, the team decides if a particular stock continues to make investment sense or it should be dumped for a better opportunity. In the process, the fund keeps booking profits too on various holdings of stocks, bonds or commodities.

Understand it this way – when you invest through a mutual fund you have outsourced the investment management job, including which stocks, bonds etc. to buy or sell, to the fund manager. You pay a decent investment management fee to do the job.

So your responsibility is to do enough diligence and research to select the right funds to take care of your money. Post that, sit tight and just review the performance on a regular basis to see if they still deserve your money or you should be moving your money to another fund.

Now let's bring back the question of profit booking in mutual funds. I believe it has to be dealt with a different perspective.

Profit booking in mutual funds or Asset Allocation?

We covered Asset Allocation earlier in the eBook. Let's extend the discussion here.

Suppose you invest Rs. 100 as per your asset allocation. Let's also assume that you invest your stocks/equity portion through equity mutual funds.

The asset allocation, original and after 1 year, is:

Asset	Original Allocation	Current Allocation	Change
Equity	40%	60%	20%
Bonds	15%	5%	-10%
Real Estate	30%	25%	-5%
Gold	10%	8%	-2%
Cash	5%	2%	-3%

As you can see, your asset allocation has changed. Equity now has a higher allocation while all others are lower than the previously decided percentages.

This could be because the stock markets went up significantly resulting in the equity portfolio getting larger in value.

One thing is clear that there is a skew in the portfolio towards equity and the deviation is significant too (+20%). This calls for a rebalancing so that we can achieve the desired allocation again.

What it means is that you should take money out from equity mutual funds and invest in other assets so as to maintain the original allocation. In this process, you will automatically need to book profits or sell your mutual funds and invest in bonds, gold, cash and may be in real estate too.

So, as far as mutual funds are concerned, this is the only thing that you should be concerned about from a profit booking perspective – your asset allocation.

Vivek was now looking at me with eyes wide open.

"*That's quite a revelation*", he finally spoke.

He continued, "*I never though of it like this. I feel it makes complete sense. If I have outsourced the job of managing my investments to the mutual fund manager, there is no point* *second-guessing him/her. I should just focus on my asset allocation."*

In conclusion

Hopefully, you realise that in mutual funds, the business analysis, stock valuations, etc. are already being taken care of by the fund managers. Based on their assessment, they also book profits as and when required. You need not duplicate the process at your end.

Also, if the fundamental attributes change and the fund falls outside of your own filters, it deserves an exit from your portfolio.

Keep a check on your fund selection parameters and your asset allocation. These are the 2 things you truly need to be concerned about.

Note: There may be times when you feel the markets have run up irrationally. That insight is not easy to get and many investors who exit, never get back in the game. That is far more dangerous.

Only, if you have the insight and the discipline to manage and execute the process, take a tactical call based on market levels. Else, you are better off following your strategic asset allocation and let it do most of the work for you.

Some other useful links on mutual funds for beginners.

Understanding NAV of a mutual fund and how irrelevant it is in your investment decision

A mutual fund dividend for all the wrong reasons

Liquid funds – Make your cash work harder

What is a direct plan vs a regular plan of a mutual fund?

How to invest online in direct plan of mutual funds?

And many Fund Stories here....

All the best!

Insider Plus from Unovest

All our tools, advice, recommendations, support from our practice bundled here so that you can use them to build and monitor your financial plan, portfolio to reach your goals, faster.

Know more about Insider Plus.