Understanding how mutual funds work

As a kid, you surely must have enjoyed parties wherein you and your friends contributed some money. You all would then buy different snacks with that accumulated sum and each one of you would eat a little of everything. Now, how mutual funds work? Well, in a somewhat similar manner.

Let's understand this.

Here's how mutual funds work

Just as you and your friends contributed money to enjoy various food items, different investors contribute money to enjoy returns.

A mutual fund investment pools the money of such investors and invests the sum into different securities such as stocks, bonds, and other money market instruments to earn returns.

When you invest in mutual funds, a certain number of mutual fund units are allotted to you. At parties, you probably ate whatever you wanted. But the working of mutual funds is much more systematic. The profits earned are distributed among investors in proportion to their mutual fund units.

Back then, any one of you would take charge of the arrangements. With mutual funds, there are fund managers. They buy and sell securities on your behalf with an aim to grow your investment value.

Your parties would be of any type – theme party, dance party, games party, etc. Similarly, you can choose your mutual fund investment type.

Types of mutual funds

SEBI, the regulator of mutual funds, has categorised mutual funds into 16 different types. However, broadly there are three types of investments in mutual funds, and these are:

1. **Equity funds:** Such funds invest in equity and equity-related securities and fall under the high risk-high return category.

2. **Debt funds:** Such funds invest in fixed income securities such as corporate bonds, treasury bills, etc. The returns are lower but so is the risk component.

3. **Hybrid funds**: Such funds invest in a mix of equity and debt and are often viewed as an investment that helps balance risks and returns.

Now that you know how mutual funds work, let's understand how you can gain from such an investment.

Benefits of mutual funds

1. **Suitable for beginners:** You can invest in mutual funds even if you don't have the time, knowledge, or expertise to manage your investments. This is because there are professional fund managers who buy, sell and track investments on your behalf.

2. **Diversification:** Mutual funds put your money in different securities, thereby reducing the risk of subjecting your money to any one particular security.

With mutual funds, you can not only diversify by investing in different asset classes but can also diversify by investing in the same asset class since mutual funds have various sub-types.

3. **Affordable:** You can invest in mutual funds with an amount as low as Rs 500/month, thanks to something that is called an SIP in mutual funds. A Systematic Investment Plan or SIP is a mode of investing in mutual funds regularly.

4. **Liquidity:** Like certain other investments, mutual funds don't block your money. Except for tax-saving mutual funds, you can withdraw your money any time with open-ended mutual funds.

5. **Tax benefits:** Equity Linked Savings Scheme (ELSS) allows you to reduce your taxable income by up to Rs 1.5 lakh annually. This means you can save up to Rs 46,800 in taxes every year.

6. **Well-regulated:** Mutual funds are regulated by SEBI which has laid strict guidelines to ensure that there is complete transparency in the working of mutual funds.

To sum it up

Mutual funds give you access to different securities in a well-regulated, systematic and transparent manner even when you may not have enough time, expertise, or savings to become an investor.