Costs incurred by Mutual Funds

Mutual funds are gaining popularity as one of the best investment vehicles mainly due to their ability to deliver attractive returns to the investor in comparison to other conventional investment methods. Also, since they are managed by professionals with expertise in the mutual funds domain, investors can be assured that their investments are handled effectively to yield optimal returns. There are certain things that one should be aware of, the most important one being the charges associated with investing. Let us look at the charges that are levied by the Asset Management Companies (AMCs) or fund houses which the investors need to incur. Cost of Mutual Funds has two components:

a. Initial Expenses at the time of establishing scheme
b. On-going recurring expenses eg. Cost of employing financial experts, administrative costs, advertisement costs

Reasons for AMCs/ Fund Houses charging investors

Mutual funds are managed by professionals who are known as fund managers. These fund managers work for the fund houses and apart from the fund managers, there is a team of capital market experts and financial analysts who work collectively to manage the investments. Managing huge investments on a daily basis requires a rich industry experience and expertise in the subject. Hence, for this task, the **AMC charges a well-earned fee to the investors** and these charges are approved by the Securities and Exchange Board of India (SEBI).

The fees include costs such as **advisory fees, operational costs, investment management fees, registrar and transfer agent fees, legal and audit fees, agent/ sales commissions, ongoing service charges**, etc. All the expenses involved in the management of mutual funds are together known as the **total expense ratio (TER)** and in simple terms, it is the fee charged by a particular mutual fund scheme to manage the investments on behalf of the investor. The expense ratio is charged annually and its major components are management fees, administrative costs, and distribution fees. It is expressed as a percentage and the reporting of the NAV (Net Asset Value) is done after the deduction of all the expenses. As per the guidelines laid down by SEBI, an increase in the Assets Under Management (AUM) should lower the TER and vice-versa.

Total Expense Ratio (TER)

Total Expense Ratio of a mutual fund can be calculated using the following formula: TER = (Total expense incurred in an accounting period X 100) / Total net assets of the fund.

Other charges associated with mutual fund investments

Mutual Fund Loads**:** Mutual fund loads are the one-time charges levied at the time of investing in a mutual fund scheme or at the time of exiting a mutual fund scheme. The charges applicable are as follows:

Entry Load – This is charged at the time of investing in a mutual fund scheme. This amount is deducted from the fund's Net Asset Value (NAV). Different fund houses charge different entry load fees. Generally, the charges are 2.25 per cent of the investment value. However, as per a recent regulation by the SEBI, fund houses can no longer charge an entry load.

Exit Load – When an investor exits from a mutual fund scheme within a short span of holding the same, an exit load has to be paid. This fee is levied in order to discourage investors from opting out of the scheme and to reduce the number of withdrawals. Different fund houses charge different entry load fees, depending on a predetermined holding period.

Entry loads and exit loads help to compensate the distribution costs.

Transaction Charges – A nominal amount has to be paid by investors as transaction fees. This is a fee which is charged only once during an investment. A transaction fee of Rs. 150 for new investors and Rs. 100 for existing investors, can be charged on investments worth Rs. 10,000 and above. Transaction charges are paid to intermediaries or distributors selling the fund.

Other Costs – There are some indirect costs incurred by investors during the investment tenure. This includes charges related to opening a demat account, maintaining the demat account, brokerage charges, etc. While buying and selling stocks, a security transaction tax is levied which has to be paid by investors.

Return from Mutual Funds

There are three types of returns from Mutual Funds:

1. Dividends
2. Capital Gains Disbursement
3. Change in NAV over the period

The return from a Mutual Fund can be computed by using the following formula:

Return = ((Dividend$_1$+ Capital Gains$_1$+ NAV$_1$ – NAV$_0$)/ NAV$_0$) X 100

Where:

Dividend$_1$ = Dividends for the period

Capital Gains$_1$ = Capital Gains realised

NAV$_1$ = NAV at the end of the year

NAV$_0$ = NAV at the beginning of the year

Sources for the E-Content

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Disclaimer

1. These notes are only for the students.

2. These notes are prepared after referring various books and websites.