Transparent & Low Cost Structure of Mutual Funds

There is a cost attached to every service that we enjoy. Mutual funds offer the service of professionally managing investment portfolios, at an annual fee. The asset management company (AMC) which manages the funds, the custodian who is responsible for maintaining the funds and securities, the R&T agent who maintains the investor records, distributors who bring the investors to the fund, the trustees, the auditors, all charge a fee for their services.

Fund running expenses

The cost of managing the fund is not imposed separately on the investor but charged to the investment portfolio. Fund running expenses is an indirect charge incurred by investors. For example, if a pool of Rs.100cr is invested and is worth Rs.120cr after a year. The return is 20%, but this is before charging costs. If the fund charges a cost of 1% on the portfolio, the value of the portfolio would be Rs.119cr and the return would be 19%.

Expenses are regulated

But a mutual fund cannot charge costs as it wishes. SEBI's Mutual Fund Regulations lay down the type of costs that can be charged to the investors. Only those expenses that can be directly related to a scheme, such as investment management fee, custodian, R&T agent and other constituents, can be charged to investors. Costs of maintaining offices, employee costs, technology used in its office and general marketing expenses cannot be charged to the scheme. Such expenses are borne by the AMC out of the investment management fees that they charge to the scheme.

Maximum limits are imposed

The regulations also specify the maximum limit of the expenses that can be recovered from the investors every year. For equity schemes the maximum limit that can be assigned is 2.5% of the assets of the fund while for debt funds the limit is 2.25%. The investment management fee is a part of these total costs, and cannot exceed 1.25% If the actual costs of managing the fund overshoot these limits, then they have to be borne by the AMC. In reality, the actual expense ratios can be much lesser, due to the competitive nature of the mutual fund industry Expenses vary from fund to fund and based on type of fund. However, the cost structure is very transparent and low also.

Expenses are part of the NAV

The expense that a fund recovers from a scheme is expressed as a percentage of the assets of the scheme. This is called the expense ratio of the fund. To ensure that investors pay their share of the expenses for each day that they remain invested, mutual funds divide the annual estimated expenses by 365 days to arrive at the expense for each day. This figure is then deducted from the portfolio value to calculate the daily NAV of the scheme. An investor who holds units in the scheme for 30 days pays expenses for that many days. Charging all expenses on a single day, say year-end, will not only depress the NAV on that day, but is also inequitable.

All expenses are disclosed

The charges that will be charged to a fund are mentioned in the Scheme Information Document of the scheme. Investors need to evaluate the expense ratio and exit loads and also compare them with other similar funds to see if they are competitive. Though the expenses may seem as a small percentage they must form an important part of the fund evaluation process. However, given the fact that the cost structure is made known upfront in a transparent manner there are no hidden surprises and their impact for a long-term investor could be marginal. This is yet another reason why investing through the mutual fund route could be to your advantage.

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An Investor Education Initiative

Mutual fund investments are subject to market risks. Please read the scheme information document carefully before investing.