

Mutual funds - It is worth taking the risk!

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In brief

Indian investors tend to be conservative. They prefer parking money in savings accounts or fixed deposits at banks or post offices.

Indian investors tend to be conservative. They prefer parking money in savings accounts or fixed deposits at banks or post offices. When it comes to investment products, apart from fixed deposits, their choices are mostly restricted to recurring deposits, Kisan Vikas Patras, National Savings Certificates, and other similar government small savings schemes.

The primary reason is the belief that their money is safe. In other words, a major reason why the Indian investor does not choose equity market products for his investment portfolio is because of the high levels of risk that need to be assumed.

Though the equity market and its products are indeed risky, looking at risk in isolation is not the correct way to create a portfolio. If, for the assumed level of risk, the returns are high enough, then that instrument can be an asset for one's portfolio. It is the same with equity markets.

But there is another issue here: How to select the right stocks? This is a more severe issue than the risk-reward one as retail investors will not usually have the expertise for stock selection. But what if there was an instrument that addressed both these issues?

There is such an instrument available to investors, which is mutual funds. The same can be seen with some index funds too. But it all depends on the needs. Some people prefer to have index funds, and on the other hand, some prefer mutual funds. For example, you can see the index funds UK list sometimes preferable to the mutual fund list.

Mutual funds are essentially pools of investments created by fund companies. These baskets of investments invest in various financial instruments ranging from stocks to bonds and commodities to currency and bullion. Funds allocate the pooled investments into the asset above classes according to their investment objective.

Given that investors' money is still invested in stocks and bonds, which are riskier than traditional investment avenues, which aspects of funds make them worth the risk? Let's look at a few of them below:

The benefit of professional management:

Mutual funds take care of the worry of choosing individual securities for a portfolio. Not just that, as an investor, one gets the services of professionals who choose stocks and bonds which constitute the fund's portfolio. Their expertise allows superior returns while reducing the risk as much as possible. This is a key feature that makes mutual funds popular.

For this service, these funds charge a management fee, which forms part of the fund's expense ratio. For a fund with consistent performance, this expense is worth paying.

Portfolio diversification:

As outlined earlier, a mutual fund is an investment pool that spreads this money across asset classes based on its investment objective. This takes care of the problem of 'keeping too many eggs in one basket.' But, again, the reference is to be too concentrated on a particular asset class or industry.

For example, an investor may have a portfolio focused on the banking sector. Till such time that banking stocks are doing well, his portfolio will outperform those of others. After that, however, any downturn will mean a nosedive in his returns.

To avoid this situation, such an investor would be advised to diversify his portfolio. This means adding stocks from other sectors and industries, which would help him sustain a downturn in a particular sector or industry.

This portfolio diversification is also a key feature of mutual funds because they spread their money across asset classes, market caps, sectors, and industries by design. This helps reduce the risk for an investor.

A lot to choose from:

So far, we have kept a close eye on the risk management aspect of funds by indicating that professionals handle the invested money and that portfolio diversification helps diversify risk. But another significant benefit of mutual funds is the massive number of choices investors have to choose from.

Mutual funds are differentiated by their investment objective, which can vary from a market cap focus (large-cap, mid-cap, small-cap funds, and diversified or multi-cap funds), sectoral focus (banking, technology, pharmaceutical, etc.), and strategy and objective focus (focused funds, balanced funds, value funds, etc.) This choice allows investors to add variety to their portfolios and put the expertise of fund managers and their teams to good use.

Risk management:

Since risk is our key theme in this article, let's look at this feature of mutual funds in-depth. Market risk, systematic risk, and unsystematic risk are factors that keep potential investors in financial markets at bay. However, it is important to note that systematic risk cannot be avoided because it is in the needs blueprint. Therefore, mutual funds try to lessen the unsystematic risk in investments by using portfolio diversification and professional management.

To reap superior returns, investors have to assume different levels of risk; usually, the higher the expected returns, the more the chance that needs to be taken. Professional fund management experience helps fund managers avoid securities that are very risky but have a low potential for returns. Instead, they use their knowledge to choose those securities which offer the right balance between risk and returns, given the investment objective of their fund.

Meanwhile, portfolio diversification not only spreads the investment money across market caps, asset classes, sectors, and industries, thereby increasing the sources of returns but also reducing the risk by spreading it out. As a result, if one sector or industry declines in value, other sectors and industries can help counter the decline by posting a rise or, at the very least, reducing the decline's impact.

Let's consider an example to see how diversification can contain losses. Let's assume a declining market where all sectors are witnessing falling prices. Among two portfolios, portfolio A is 100% invested in technology stocks, while portfolio B is diversified evenly across five sectors (including the technology sector).

Let's consider that the technology sector has declined by 20% while the other four have reduced by 15%, 10%, 5%, and 0%, respectively. So, while portfolio A would be down by 20%, portfolio B would be down by only 10% because of diversification. So, in a broadly declining market, diversification can help reduce losses compared to a concentrated portfolio.

Performance assessment

As the last part of this article, let's take a look at how mutual funds have performed in the past to assess whether they are worth the risk.

The following table details the performance of various categories of equity funds across periods.

Large Cap

Fund Category/Name: HDFC Top 100 Fund - D (G) | 6 Months: 14.10% | 1 Year: 16.10% | 3 Years: 16.20%

Fund Category/Name: Axis Bluechip Fund - D (G) | 6 Months: 13.50% | 1 Year: 12.80% | 3 Years: 16.60%

Multi Cap

Fund Category/Name: HDFC Equity Fund - Direct (G) | 6 Months: 14.10% | 1 Year: 15.00% | 3 Years: 16.30%

Fund Category/Name: Reliance Multi Cap - Direct (G) | 6 Months: 10.00% | 1 Year: 12.90% | 3 Years: 14.00%

Large & Mid Cap

Fund Category/Name: Mirae Emerging Bluechip -Direct (G) | 6 Months: 12.90% | 1 Year: 12.80% | 3 Years: 19.60%

Fund Category/Name: Mirae Emerging Bluechip -Direct (G) | 6 Months: 11.20% | 1 Year: 8.90% | 3 Years: 15.10%

Value Funds

Fund Category/Name: Reliance Value Fund - Direct (G) | 6 Months: 10.10% | 1 Year: 5.60% | 3 Years: 14.80%

Fund Category/Name: HDFC Capital Builder Value Fund - D (G) | 6 Months: 7.80% | 1 Year: 4.30% | 3 Years: 14.90%

Focused Funds

Fund Category/Name: Franklin India Focused Equity (G) | 6 Months: 16.90% | 1 Year: 12.00% | 3 Years: 13.50%

Fund Category/Name: Sundaram Select Focus -Direct (G) | 6 Months: 12.50% | 1 Year: 10.90% | 3 Years: 15.70%

Sectoral/Thematic

Fund Category/Name: ICICI Pru Banking & Finserv (G) | 6 Months: 19.00% | 1 Year: 14.80% | 3 Years: 21.40%

Fund Category/Name: Franklin Build India - Direct (G) | 6 Months: 17.00% | 1 Year: 11.80% | 3 Years: 15.80%

*Returns as on June 6, 2019 Source: Moneycontrol

Looking at the returns of these funds, one can see that the rate at which they can grow wealth is undoubtedly worth the risk that comes along with investing in them and provides the most convincing argument yet regarding why mutual funds are worthy of consideration.

Types of Mutual Funds Based on Risk Factor:

1. Equity Fund: In equity funds, money is pooled by various investors, which is then invested in the stock market by the fund manager. The money is not invested entirely into equity but is split into 60-40 or 80-20, where a small ratio is invested in other financial instruments.

The profit or loss from this type of fund depends on how well the stocks perform. The various equity mutual funds in India that give really good returns are L&T India Value Growth, Aditya Birla Sun Life Frontline Equity Fund Growth, SBI Bluechip Fund Regular Growth, etc.

2. Debt Fund: Debt Funds consists of government bonds, liquid funds, short-term plans, etc. These funds mostly invest in financial instruments that generate fixed interest. When you opt to invest in debt funds, a fixed interest rate and a maturity period will be given to you. The fund manager invests in high-rated securities, which have low volatility, to earn high returns.

There are short-term debt funds with a tenure of 3 months to 1 year and medium-term debt funds with a term of 3 to 5 years. Many people invest in debt funds as they grow older to gain more security while investing in mutual funds. Some good debt funds to invest in are Reliance Low Duration, Aditya BSL Savings Fund, L&T Low Duration Fund Growth, etc.

3. Index Fund: In index funds, you invest in the index of a benchmark like Nifty, which consists of the 50 best-performing stocks. Index funds are passively managed because there is no requirement for investment strategies. The fund manager just tries to replicate the benchmark index. The popular indices of India are the NSE (National Stock Exchange) Nifty and BSE (Bombay Stock Exchange) Sensex. But sometimes, the returns may not be the same as the returns of an index due to tracking errors.

Tracking error is mainly the difference between the returns you earn from index funds and the benchmark index it was supposed to replicate. Fund managers try to keep the tracking error to a minimum to gain maximum returns. Some of the best index funds in India are HDFC Index Nifty 50, Aditya Birla Sun Life Index Fund Growth, IDFC Nifty Fund Growth, and so on. You can also read more about some of the best index funds in India to invest in.

4. Tax-Savings Fund: Tax-savings funds mainly consist of ELSS (Equity Linked Saving Scheme). ELSS allows investors to save on taxes and also earn good returns in the long term. This type of investment qualifies for tax deductions, under Section 80C, of INR 1.5 lakhs. Investors can get tax benefits by investing their income in equity schemes.

But it is advised to go for long-term investments because the risk factor is high, with increased volatility in the short term. However, if you are open to holding your assets for longer, ELSS can give you high returns. Some good ELSS mutual funds in India are Reliance Tax Saver Fund, Axis Long Term Equity Fund, SBI Magnum Tax gain Scheme, etc.

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