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Stop Loss in Mutual Fund investments: Maintaining the gains, Preventing the losses

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Introduction

A mutual fund is a pool of money from numerous investors who wish to save or make money. Investing in a mutual fund can be a lot easier than buying and selling individual stocks and bonds on your own. Investors can sell their shares when they want.

Mutual fund investments are chosen and monitored by qualified **professional fund managers** who use this money to create a portfolio, which consist of stocks, bonds, money market instruments or a combination of those.

Diversification of funds is USP for mutual funds as it provides multi flavoured benefits from single source. By investing in mutual funds, you could diversify your portfolio across a large number of securities so as to minimisethe risk.

During last decade, middle class preferred fixed deposit, PPF, NSC and other similar fixed income securities for investment. Reason for choosing such safe alternatives were securing their hard earned money from stock market scams, overall economic policies and depressing international environment.

Still there has been gradual increase in investor base and funds towards mutual funds. This trend was not so popular but attention catching for investors. It helped to gain popularity for various alternatives under mutual fund option especially **SIP.**

This paper aims at analyzing the need of **stop loss in mutual fund investments like in stock market investment in order** to **maximize** the **returns** to the investors with **reduced risk.**

Objectives:-

- To study the mutual fund schemes giving negative returns over past few years.
- To prove the benefits of stop loss mechanism in mutual fund schemes which are highly exposed to risk eg. Midcap funds, small cap funds, sector funds.

Research methodology:

Research paper is based on historical data relating to performance of selective mutual fund schemes.

Limitations:-

This study is limited to comparison between the returns delivered by selected mutual fund schemes from midcap, small cap &sector funds over a period of last 10 years.

Contents

1. Concept of mutual fund

A mutual fund is a collection of investments, such as stocks, bonds and other funds owned by a group of investors and managed by a professional money manager. The investment objective of the mutual fund determines what types of securities it buys. A mutual fund can focus on specific types of investments. For example, a fund may invest mainly in government bonds, stocks from large companies, or stocks from certain countries. Or, it may invest in a variety of investments.

When you buy a mutual fund, you're pooling your money along with other investors. You put money into a mutual fund by buying units or shares of the fund. As more people invest, the fund issues new units or shares.

The investments in a mutual fund are managed by a portfolio manager. They manage the fund on a day-to-day basis, deciding when to buy and sell investments according to the investment objectives of the fund.

Net asset value (NAV)

When we purchase or redeem securities of a mutual fund, we pay or receive what is known as the net asset value (NAV) of the security at the time of purchase, switch or redemption. Most mutual funds report their NAV daily in the business section of many newspapers, or on the fund manager's website. NAV represents the mutual fund's assets less its liabilities. NAV will fluctuate with changes in the market value of the mutual fund's particular investments.

<u>Benefits of mutual fund investments</u>

Mutual fund investment provides various benefits as compared to other alternatives like shares, FD, Insurance schemes, ULIP, PPF.

1. Built-in diversification 2. Professional management

3. Easy to buy and sell

4. Variety of schemes

5. Limited risk as compared to share market

6.Capital appreciation

7. Liquidity

8. Minimum Lock in period:

<u>**Types of mutual funds**</u>:-

1. **Money market funds / Bond fund**

2. **Fixed income funds**

3. **Equity funds**

4. **Balanced funds**

5**. Index funds**

6. **Specialty funds / Sector funds**

7**. Fund-of-funds**

8. Open ended & close ended funds

<u>Need for a STOP LOSS in mutual fund investments</u>

Mutual fund investments are subject to market risk. Please read scheme information document carefully before investing. This statement itself reveals that you can get higher returns but with a risk factor. So risk in mutual fund is less but not NIL.

So in order to avoid the risk, an investor either takes an advice of financial advisor or opts for low risk low return scheme like debt and liquid schemes..

Financial advisor cannot assure zero risk. But advices to invest through SIP so that the investor can earn good returns in long term by averaging various ups and downs in the market. SIP is better option than one time investment in the scheme as it avoids the losses due to investing at a peak point in the market.

In order to reduce the risk and get higher returns, the financial advisor normally suggests SIP.

SIP:- (Systematic Investment Plan)

A systematic investment plan (SIP) is a plan where investors make regular, equal payments into a mutual fund, trading account or retirement account, regularly without taking any actions except the initial setup of the SIP. This amount is used for buying a security regardless of its price, Security/shares are bought at various prices, the average cost per share of the security decreases over time and the risk of investing a large amount of money into a security lessens.

SIP has its benefits like averaging the ups and downs in the market. In addition the investor can invest on monthly basis. However the investor can choose the date of investment at the beginning only. As a result SIP amount automatically enters the scheme even at peak point. This automatically reduces the overall returns to the investor.

On the other hand past performance of the scheme may not be continued in the future. So SIP has one more condition of staying invested in same scheme even if the scheme is not performing well. Another way to avoid loss due to underperformance of mutual fund scheme is switching periodically from underperforming scheme to top performing scheme. In such situations, the financial advisor has to review the portfolios of the clients to suggest switching to new scheme or staying invested in the same scheme.

To overcome these issues, an investor has to wait for correction in the market so that he can get more units allotted at lower NAV.

Negative returns of various mutual fund schemes

MID CAP MUTUAL FUND SCHEMES	2008	2011
Taurus Discovery Fund - Regular Plan |	-75.17	-30.45
BNP Paribas Midcap Fund |	-72.29	-20.76
SBI Magnum Midcap Fund |	-71.74	-25.79
SBI Emerging Businesses Fund |	-68.54	-10.58
ICICI Prudential Midcap Fund |	-67.8	-32.6
SBI Magnum Global Fund |	-66.65	-14.2
Kotak Emerging Equity Scheme Regular Plan |	-65.22	-26.64
Invesco India Mid Cap Fund |	-64.18	-17.5
Kotak Mid-Cap Regular Plan |	-62.92	-26.9
Franklin India Prima Fund |	-62.46	-22.06
UTI Mid Cap Fund |	-61.17	-23.89
Tata Midcap Growth Fund - Regular Plan |	-60.23	-22.69
Escorts Growth Fund |	-59.16	-35.06
DSP BlackRock Midcap Fund - Regular Plan |	-58.46	-27.21
Aditya Birla Sun Life Mid Cap Fund |	-58.41	-26.45
Sundaram Select Midcap Fund - Regular Plan |	-58.34	-23.67
Reliance Mid & Small Cap Fund |	-54.64	-28.61
Reliance Growth Fund |	-54.11	-27.4
IDFC Premier Equity Fund - Regular Plan |	-53.14	-18
ICICI Prudential Indo Asia Equity Fund |	-50.6	-15.05
BNP Paribas Dividend Yield Fund |	-48.16	-17
Aditya Birla Sun Life Dividend Yield Plus Fund |	-44.44	-18.81

SMALL CAP MUTUAL FUND SCHEMES	2008	2011
Aditya Birla Sun Life Small & Midcap Fund |	-61.51	-23.32
DSP BlackRock Small Cap Fund - Regular Plan |	-63.35	-27.16
HDFC Small Cap Fund - Regular Plan |	-	-26.21
HSBC Small Cap Equity Fund |	-65.72	-43.47
Reliance Small Cap Fund |	-	-25.04
Sundaram S.M.I.L.E. Fund - Regular Plan |	-57.62	-32.72

SECTOR FUND PHARMA	2008	2011	2016
Reliance Pharma Fund	-34.00	-11.02	-10.58
SBI Pharma Fund	-49.20	-5.54	-14.02
UTI Pharma& Healthcare Fund	-25.95	-9.55	-9.71
Tata India Pharma& HealthCare Fund - Regular Plan			-14.65

What is a STOP LOSS:-

Stop loss is a user defined limit beyond which the investment is automatically redeemed. There is no need to place separate order for redemption. Even the investor need not keep a watch on the performance of the scheme as the stop loss limit is taken care of via an automatic order.

Stop loss prevents the losses to the investor if the security price falls beyond a certain limit. So if investor has decided to wait for upward movement of market but market is continuously moving downward, then investor may suffer huge losses. So in some cases investor may lose profit previously earned as well as the capital invested. However it is a general perception that, mutual fund investments cannot be protected using stop loss as they are not traded in stock exchange like shares and other instruments. But in mutual fund stop loss can be used in a different method.

Need for STOP LOSS in mutual fund scheme:-

An investor has some long term goals while investing in mutual fund. It can be child education, marriage, purchasing house or retirement planning. If the selected scheme has performed better than benchmark in past still it is always necessary to review the investments on yearly basis.

But a common investor has no time to review the returns and performance of the schemes. So financial advisor has to look into the matter and advice the client for switching from underperforming scheme to best performing scheme.

Sudden fall in the market or change in fund management by AMC may wipe out the gains of the investor. So in order to protect the investor from losing hard earned money it is better to apply stop loss for the mutual fund scheme investment.

Facility of stop loss:-

- Stop loss can be applied by AMCs (Asset Management Companies) to all schemes on uniform basis or as per investor choice.
- Stop loss can be provided as an option for investor.

- **Stop loss limit can be user defined at the time of purchase.**
- **It can be applied any time during the investment period.**
- AMC may charge certain amount as service charge for providing this service.

How to fix the STOP LOSS limit:-

1. Stop loss can be fixed at certain % below the invested amount.
2. Stop loss can be set after comparison with the benchmark by choosing underperforming scheme.
3. Option of automatic redemption of full investment or partial investment can be given.
4. Trailing stop loss is also useful where investor can protect the gain and set the higher stop loss limit periodically for his investment.
5. Stop loss % can be applied on monthly/quarterly/half yearly or yearly opening balances to prevent the gain up to the specified date.

Benefits of STOP LOSS in mutual fund schemes

1. Avoid losses in market corrections
2. Protect the gains using trailing stop loss for better performing schemes.
3. Financial advisor is not necessary for review of investments
4. Automatic redemption from underperforming schemes
5. Automatic Periodical update of portfolio

Drawbacks of Stop loss application:-

1. Stop loss application may increase redemption transactions during market corrections.
2. Exit load is applicable in case of underperformance within first year of investment
3. Long term investors using INVEST & FORGET will have to review their investments in high risk plans like mid cap, Small cap and sector schemes.
4. Not suitable for all mutual fund schemes like Tax saving schemes, fixed maturity plans.
5. It is useful for equity oriented schemes only. For debt schemes and liquid schemes it is not applicable.

Example:-

A person has invested Rs.1,00,000 in a mutual fund growth scheme in January 2012. Market value of his investment on 1st January 2017 is Rs.3,00,000.

Suddenly there is an adverse news at global level and market crashed severely. Value of his investment on 1st January, 2018 remains at Rs.1,30,000. The person has lost a notional gain of Rs.1,70,000 due to market fluctuations. This situation can be avoided by stoploss technique as follows.

If he would have opted for **quarterly stop loss** at **10% level.**

In falling market, on 1st April 2017 his market value would have been calculated. If it is less than Rs.2,70,000 (i.e. 10% less than last quarter opening of Rs.3,00,000 on 1st January, 2017) an automatic redemption order would have been triggered. The investor would have maintained his gain even in falling market.

AMC can provide the option of choosing monthly, quarterly, half yearly or yearly stop loss review as per the service conditions.

CONCLUSIONS

Stop loss is always necessary in stock market in order to avoid huge losses. However mutual fund investors are completely dependent on fund manager who operates the mutual fund scheme. Those who are willing to take high risk in mutual fund by investing in high risk plans like Mid cap, Small cap and sector schemes need to review their investment periodically.

The schemes performing well at present may suddenly underperform due to change in asset allocation by fund manager or appointment of new fund manager.

Stop loss in mutual fund scheme can protect the investor from losses due to underperformance of a scheme to achieve the long term financial goals. Stop loss technique can make mutual funds safer for investment.

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