Fund of Funds: A One-Stop Solution for Investors

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Fund of Funds (FoFs) are a category of pooled investments which invests across Mutual Funds, Exchange Traded Funds, Alternative Investment Funds, etc. Just as an equity mutual fund scheme invests in stocks directly and a debt mutual fund scheme invests in bonds directly, a FoF purchases units of these equity and debt mutual funds schemes, effectively becoming a mutual fund investing in other mutual funds. Each FoF has a distinct investment objective and publishes its NAV on a regular basis just like any other mutual fund.

For instance, you wish to invest Rs.10,000 across various asset classes but is unsure how to go about it. While you do want your investment to generate returns, you are not adept at researching stocks, bonds, ETFs and commodities, tracking macro developments, monitoring your portfolio, and so on. In such a situation you can opt to invest in equity, debt and gold schemes separately across various fund houses.

The other option is to invest in a FoF which will invest in equity, debt and commodity oriented mutual fund schemes of the same fund house or various fund houses. In such a fund a certain percentage of the portfolio will be allocated to each of the asset classes the fund is allowed to invest into, thereby simplifying your investment approach. At the same time, you have a fairly diversified portfolio as well at no additional cost.

Within the FoF universe, there is a wide variety of offerings available. FoFs have the flexibility to invest across active and passive funds in their underlying portfolio. The common types of FoF are as follows:

Asset Allocation FoF - These are funds with a portfolio mix of equity, debt and commodities. Here, the allocation to various asset classes could be static or dynamically managed as per the changing market conditions. In a static asset allocation fund, the asset allocation is maintained in a fixed proportion. On the other hand, a dynamically managed asset allocation will continually tweak allocation to benefit out of the prevailing market conditions. In effect, these funds not only help stem market volatility, but also provide the benefits of diversification, along with ensuring optimal returns.

International FoF- These are funds which invest in units of an international mutual fund. They help provide geographical diversification to the portfolio and help access international securities markets at a very low cost.

ETF FoF - These are funds which invest in an Exchange Traded Fund (ETF). ETFs are effectively a basket of stocks or bonds or commodities, which are traded on the Stock Exchanges. An ETF FoF can help create a diverse portfolio by investing in a variety of ETFs. Inorder to invest in an ETF, investors need access to a demat account. But when it comes to ETF FoF, there is no such requirement.

Multi Manager FoF - These are funds which invest in other mutual funds, which have varying portfolio concentration, across one or more asset classes. This is the most common form of FoF, where each asset class is managed by an individual fund manager from different fund houses. For example: ICICI Prudential India Equity FOF. The fund has exposure to equity schemes of varying styles across at least five or more different fund houses.

Gold FoF - These are funds which invest directly or indirectly in gold. The investments here can be in physical gold, gold ETF or even entities involved in mining, producing and distributing gold. While gold funds do help gain portfolio exposure to precious metals, they also help protect the portfolio against rising inflation.

Advantages

Portfolio Diversification - FoFs help diversify an investor's portfolio with ease by investing across different asset classes or investing in a variety of instruments within the same asset class. By investing in the schemes of existing mutual funds, FoFs reap the benefit of investing in the best performing funds without as much effort.

Effective Portfolio Management - FoF effectively help create and manage a well-diversified portfolio at significantly lower costs. The investor is only required to choose a FoF which matches their investment criteria and is ensured that his/her investment is managed by well-trained professional fund managers, with much greater accountability and transparency.

Low Costs - FoFs work on similar lines as mutual funds and as a result, investors can gain exposure to various securities without having to pay additionally for demat accounts, trading accounts, etc. For example, an investor intending to gain exposure to the Nifty50 Index need not purchase the underlying stocks / ETF through the stock exchange (which requires a demat and a trading account); they may invest in a FoF which invests in the Nifty50 ETF or a Nifty50 Index Fund.

Low Capital Requirement - FoF enable investors to gain exposure to various securities for as low as Rs. 500. So, investors need not wait to generate a large corpus to start investing in a FoF. Investor can initiate a monthly SIP and invest systematically over a period of time.

Tax Implications - Investors do need to be mindful about the tax implications of investing in FoFs. FoF in general is treated as a debt fund for tax purposes. It implies that Short Term Capital Gains (STCG) are applicable if profits are generated when the FoF holdings are sold within 3 years of purchase. STCG is applicable at the income tax slab rate of the investor, while Long Term Capital Gains (LTCG) are taxed at 20% with indexation benefits.

However, the exception to this is if it is an equity oriented FoF. In this case, profits are taxed as long term if the FoF units are held for more than 12 months. The LTCG on units of equity FoF are taxed at flat rate of 10% while the STCG on equity FoF are taxed at flat rate of 15%.

To conclude, FoFs are a great investment vehicle for any investor wishing to foray into the securities markets. Given the structure and variety of offerings available, FoF has emerged as a one-stop-shop for an investor's investment needs. FoFs have ensured that complex decisions such as diversification and asset allocation are streamlined to help benefit the least-savvy investors and help promote the best practices of portfolio management while being extremely affordable.