Risk Profile and Mutual Fund Scheme Selection of Investors

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ABSTRACT *Investors in general may have different risk tolerance levels. Hence, mutual funds in particular offer various schemes ranging from very low to very high risk. Depending upon the objective of investment, investor can choose mutual fund scheme which suits to his risk profile for Risk tolerance level. However, there is always a possibility of mismatch between the risk profile of investor and the mutual fund schemes selected by him. This mismatch can defeat the whole purpose of making investment in mutual funds for the investors. The present study attempts to investigate if mutual fund schemes selections show their suitability to various risk profiles of mutual fund investors. Based on a sample of 200 respondents, the study has found that there is a significant Association between risk tolerance level and risk level of mutual funds scheme selected by investors. However, there have also been instances of mismatch of risk profile and mutual fund schemes selection reported in the study.*

Key words: *Risk Profile, Mutual Funds, RiskoMeter.*

1. Introduction

Mutual Funds are termed as ideal products for retail investors for many reasons. These reasons include lesser time and expertise for equity market investing, inadequate funds to diversify portfolio etc. However, within Mutual Funds also, there are lot of different schemes to choose from for the investors. Although, these schemes have been designed with the purpose of catering to various risk profiles of investors, often there is a mismatch. This mismatch can cause huge losses to investors. An investor with low risk profile invest in high risk mutual fund scheme, he may have to suffer huge losses. On the other hand, if an investor with high risk profile, chooses to invest in low risk mutual fund scheme, he may not get adequate return on his investment. Hence, it becomes important for investors to understand their risk profile and choose mutual fund scheme which suits their risk profile. This paper is an attempt to examine if investors select mutual fund schemes suitable to their risk profile or they just invest in mutual funds without considering it.

1.1 Risk Profile of Investors

Risk profile of investors can be divided in two parts i.e. Time Horizon and risk tolerance. Time Horizon indicates duration for which mutual fund investor can stay invested and at the time of withdrawal of Investments, the time within which an investor plans to spend this money. In general, a longer time horizon is preferred as it can minimise the effect of short run ups and downs of market. Risk tolerance is related to the ability of an investor to absorb the loss from mutual fund investment. Higher the risk tolerance, better may be the chances to gain from mutual fund Investments. Investors with long term investment Horizon can invest in various avenues with high risk involved and higher returns expected. However people with low risk tolerance or with low time Horizon can opt to invest only in short term securities with low risk and low but guaranteed Returns. Ideally, investors in their 20s or 30s have more time horizon and high risk tolerance as compared to people in 60s and 70s or nearing retirements.

1.2 Risk O Meter of Mutual Fund Schemes

Risks are inherent in mutual fund Investments. In order to help investors to be aware of various types of risks involved in mutual funds schemes, SEBI made it mandatory for all the mutual fund houses to display a riskometer diagram which indicates the degree of risk involved in any specific mutual fund scheme. Riskometer was made mandatory from 1st July 2015. Riskometer is a semicircle design with colour codes indicating risks of investment in in any particular mutual fund scheme.

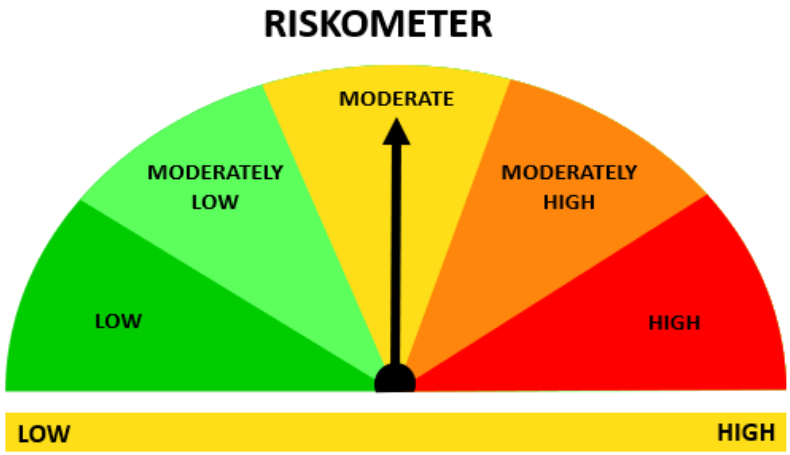

Figure-1: Sample RiskoMeter

As shown in figure-1, riskometer has five levels of risk. These levels of risk range from low risk level to high risk level. These levels specifically include low risk level, moderately low risk level, moderate risk level, moderately high risk level, and high risk level. Low risk level mutual fund schemes include gilt funds, money market funds and fixed maturity plans. These schemes tend to be appropriate for investors with very short time Horizon. Moderately low risk level includes bonds with a short or medium term duration. Normally, such schemes are considered suitable for investors with 1-3 years' time Horizon. Moderate risk label puts principal investment at a moderate risk. Various investment avenues in this group include arbitrage funds,MIP funds, debt oriented funds etc. Investments in this group suit better to investors who want to earn a decent return on their investments and are also concerned about safety of these Investments. Moderately highest level funds generally include balanced funds with moderately high equity orientation. This category would be more appropriate for investors with a longer time horizon. Finally, highest level mutual fund schemes include sectoral funds, thematic funds, micro-cap funds etc. Although there is very high risk involved of losses, yet these funds have the potential to give exceptionally high returns to investors who stay invested for longer time horizon.

2. Review of Literature

A large number of authors have explored investment in mutual funds. Sujit and Amrit (1996)[ii] conducted a study on selected mutual fund investors and found that major factors which have influenced salary and business group are tax benefits and liquidity. Similar study was conducted by Agarwal (2001)[iii] which concluded that investors look for safety and profitability of Investments. You also found that public provident fund and debt funds for more popular among professionals, salaried class and retired persons. Tapan and Nalini (2002)[iv] also investigated objectives for investment decisions. They concluded that safety of the investment and minimum return were the most important factors for investment in mutual funds. Somewhat less, but still important factors included tax rebate for investment in mutual funds and past performance of its selected schemes.

Chalam (2003)[v] compare various investment avenues as preferred by investors. He concluded that real estate was the most charming Investment Avenue followed by mutual funds. Other avenues like investment in share market or investment in gold had somehow lost charm. Thomas (2005)[vi] found that mutual fund investors mainly look for short-term benefits like tax rebate to take decisions regarding scheme selection of mutual funds. He found that those mutual fund schemes have been subscribed and invested more which a short text benefits to investors under various sections of Income Tax Act. Similar results have also been reported by Singh & Chander (2006)[vii] and Muttapan (2006)[viii]. Ranganathan (2006)[ix] reported that investor who were nearing their retirement where to invest more in pension funds as well as provident fund. They didn't want much to invest in mutual funds as they considered that mutual funds were mainly for tax saving purpose. Hence, he proved that many investors do not consider mutual funds to be safe Investments which could cater to their post retirement life.

IIMS Data Works Report (2007)[x] examined the possibility of association between level of education and investment behaviour. However no such association could be found which leads to the conclusion that education may not be able to influence investment decision of mutual fund investors. Parihar et al. (2009)[xi] examined the influential factors for mutual fund investments. He found that the main factor was return on investment. Other important factors included liquidity, flexibility, affordability and transparency. Jeyabal and Prabakaran (2009)[xii] explored risk profile of mutual fund investor they found that majority of investors were falling in low and moderate risk tolerance groups. However there mutual fund Investments were in high risk schemes. They further advised to mutual fund groups to assess risk profile of investors and suggest schemes accordingly.

Brahambhatta et al. (2012)[xiii] conducted a study of 100 mutual funds investors. They found that most of the investors made conservative investment decisions which actually reflected a survival mode and not inclination towards higher returns. However, some investors continue to invest in mutual funds even after facing huge losses. Yogesh and Charul (2012)[xiv] analysed mutual fund investments and concluded that 88 due to the low Returns and failure to match inflation in economy, investors shift from traditional investment options like Bank deposits or post office saving schemes to mutual funds.

3. Statement of the Problem

The present study is an investigation of mutual fund scheme selection by investors. As discussed earlier, mutual fund investors have their risk tolerance levels. Ideally, mutual fund investments should be made based on risk tolerance levels. In other words, mutual fund investors should select mutual fund schemes which are suitable to their risk profile. Hence, the study attempts to examine if the mutual fund scheme selection of investor reflects their risk tolerance level.

4. Hypothesis

Null hypothesis states that mutual fund scheme selection is independent of risk profile of investors. In other words, it means that mutual fund investors do not invest in mutual funds schemes based on their risk tolerance levels.

5. Research Design

Research design for the present study has been as below.

5.1 Sample of the Study

In order to conduct survey and have primary data, a sample of 200 respondents has been selected following judgement sampling. All these investors belong to three cities i.e. Chandigarh, Mohali and Panchkula. All these investors have made and presently hold mutual fund Investments.

5.2 Data Collection Instrument

To collect primary data, a structured questionnaire has been designed covering various dimensions like time horizon, risk tolerance, and mutual fund scheme where investors have put their money. The questionnaire was pretested on 10

respondents. Thereafter it was put on web and was shared with the help of weblink.

5.3 Analytical Tools

Data analytical tools include calculation of frequencies and percentages. Besides, cross tabulation has been made between risk tolerance level and mutual Funds schemes selected by investors. Finally, chi square test to test the association between risk level of scheme selected and risk tolerance level of investor.

6. Data Analysis

Table 1 shows the investors profiling. To begin with, investment time Horizon has been covered. It has been divided in four groups including up to 3 years, 3 to 5 years, 5 to 10 years and more than 10 years. It can be observed that a majority of the respondents have a time Horizon of more than 10 years followed by respondents with a time horizon of 5 to 10 years. 12% of the respondents have time Horizon of up to three years only. Post withdrawal spending are concerned, a vast majority of respondents plan to to immediately spend the amount withdrawn whenever they withdrawal money from mutual funds followed by respondents who may spend money within two years and then within 2 to 5 years.

From knowledge point of view, about 73 respondents feel that they are fully aware of mutual fund Investments followed by 57 respondents who claim to be adequately aware.

Table-1: Investors' Profiling

		Count	Column N %
Investment Time Horizon	Up to 3 years	24	12%
	3-5 years	46	23%
	5-10 years	57	29%
	More than 10 years	73	37%
	Total	**200**	**100%**
Post Withdrawal Spending	Immediately	73	37%
	Within 2 years	57	29%
	From 2-5 years	46	23%
	After 5 years	24	12%
	Total	**200**	**100%**
Knowledge	No/Little Awareness	24	12%
	Somewhat Awareness	46	23%
	Adequate Awareness	57	29%
	Full Awareness	73	37%
	Total	**200**	**100%**
Objective	Capital Preservation	11	6%
	Tax Savings	37	19%
	Children Education	22	11%
	Life Style Improvements	57	29%
	Retirement Planning	23	12%
	Capital Appreciation	50	25%
	Total	**200**	**100%**
Risk Tolerance	Up to 10% Loss	48	24%
	Up to 25% Loss	102	51%
	Up to 50% Loss	35	18%
	After 50% of Loss	15	8%
	Total	**200**	**100%**

Thereafter respondents have been asked to specify the objective for which they have made mutual fund investment. For this purpose, six objectives have been specified in order of time. Very short term objectives include capital Preservation and tax saving. Thereafter children education and life style improvement have been covered. Finally retirement planning and capital appreciation have been covered which require a longer time horizon. Two major objectives which have been pursued by the respondents include lifestyle improvement and capital appreciation. Very few of the respondents have marked capital preservation as their objective.

Finally, risk tolerance has been assessed for the respondents. Risk tolerance has been assessed from the point of view of maximum loss that can be absorbed by the respondents or investors. In other words, this would be the limit of loss after which they will liquidate their Investments. It is clear that about 75% of the respondents will not be absorbing more than 25% of loss of their investment. It seems that investors do not have very high risk tolerance.

On the basis of five parameters covered in table 1, risk profile of investors has been calculated and further divided into three groups consisting of low risk tolerance, moderate risk tolerance and high risk tolerance. Table 2 shows that majority of the respondents are having moderate risk tolerance. Thereafter, 37% of the respondents have high risk tolerance and 24% of the respondents have low risk tolerance. Thus, about three fourth of the respondents fall into moderate and high risk tolerance zone.

Table-2: Risk Profile of Investors

Risk Profile	Count	Column N %
Low Risk Tolerance	48	24%
Moderate Risk Tolerance	79	40%
High Risk Tolerance	73	37%
Total	**200**	**100%**

Table 3 shows the RiskoMeter of mutual funds schemes where the respondents have invested their maximum of investment. 38% of the respondents have invested in moderately high risk scheme followed by 26% of the respondents in high risk schemes. 16% of the respondents have moderate risk investment in mutual funds. Remaining 22% of the respondents have invested in low risk for moderately low risk mutual Fund schemes. It is clear that more than 60% of the respondents have invested in high to very high risk mutual fund schemes.

Table-3: Riskometer of Mutual Fund Scheme of Investors

MF Scheme	Count	%
Low Risk	17	9%
Moderately Low Risk	25	13%
Moderate Risk	31	16%
Moderately High Risk	75	38%
High Risk	52	26%
Total	**200**	**100%**

Table 4 shows the association between risk profile of investors and mutual fund scheme selection by investors. It can be observed that from low risk tolerance investors, 35% have invested in in low risk mutual fund schemes and 25% of respondents have invested in moderately low risk schemes. However in this group, about 25% of the respondents have invested in moderately high or high risk mutual fund schemes. Such investments may be very risky for these investors keeping in mind their risk tolerance level. In case of

moderate risk tolerance level investors, 59% have invested in moderately high risk schemes and 8% invested have invested in high risk mutual fund schemes.

16% of the respondents have invested in moderate risk and last 16% have invested in moderately low risk mutual fund schemes. It can be observed that more than 65% of respondents in this group have assumed moderately high to high risk which may not be very appropriate for this group. Finally, high risk tolerance group has been covered. 58% of respondents in this group have invested in high risk mutual fund schemes followed by 27% respondents in moderately high risk schemes. 15% of the respondents in this group have invested in moderate risk mutual fund schemes. These investors main somehow feel low due to lesser returns on their Investments compared to their risk profiles.

Table-4: Risk Profile and Mutual Fund Scheme Selection by Investors

Risk Profile		MF Scheme (Max. Investment)					
		Low Risk	Moderately Low Risk	Moderate Risk	Moderately High Risk	High Risk	Total
Low Risk Tolerance	Count	17	12	7	8	4	48
	%	35%	25%	15%	17%	8%	100%
Moderate Risk Tolerance	Count	0	13	13	47	6	79
	%	0%	16%	16%	59%	8%	100%
High Risk Tolerance	Count	0	0	11	20	42	73
	%	0%	0%	15%	27%	58%	100%
Total	**Count**	**17**	**25**	**31**	**75**	**52**	**200**
	%	**9%**	**13%**	**16%**	**38%**	**26%**	**100%**
Chi-square*			**df**			**Sig.**	
131.74			**8**			**.000***	

*. The Chi-square statistic is significant at the .05 level.

In order to assess the significance of the association discussed above between risk profile of investors and risk in scheme selected by them, chi square test has been applied. Null hypothesis in this case is that mutual fund scheme selection is independent of risk profile of investors. In other words, it states that mutual fund investors do not invest in mutual funds schemes based on their risk tolerance levels. Chi square value has been found to be 131.74 which is significant at 5% level of significance. Hence the null hypothesis is stated earlier stands rejected. It can be claimed that mutual fund scheme selection of respondents is associated with their risk profile or risk tolerance level.

For all the three groups based on risk profiles, some of the respondents have not selected mutual fund schemes based on their risk profiles. Follow risk tolerance level investors, risk Investments can cause huge losses. And for high risk tolerance investors, moderate risk mutual fund schemes may not in the expected Returns. Hence, it can be observed that also mutual fund investments somewhere prove linkage with investor risk profiles, yet investment strategies of few investors may not be appropriate to their risk tolerance levels.

7. Conclusion

To conclude the study, it can be said that mutual fund scheme selection by investors do reflect the consideration of respective risk tolerance levels. However, they have been instances of a clear mismatch. Many investors with low risk tolerance level have invested in high risk Mutual Fund schemes they can potentially lose their capital. Similarly, some

investors with very high risk tolerance have made Investments in low to moderate risk mutual fund schemes which may not be able to yield expected returns. Hence, it is advisable that mutual fund investors should find their risk tolerance levels first and then invest in suitable mutual fund schemes. They should not be tempted to make investment in high risk high return schemes if they do not have similar risk tolerance level. It is also suggested that all mutual fund houses should have some kind of helpful tools for calculators for investors to assess their risk tolerance levels.

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