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IMPACT OF EXPENSE RATIO ON MUTUAL FUND INVESTMENT

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Abstract:

An expense ratio shows how much a financial institution costs investors to manage a portfolio, mutual fund, or exchange-traded fund (ETF). The ratio shows the fund's total management and operating costs. The expense ratio is derived by dividing the operational expenditures of a mutual fund by the total dollar value of all the assets in the fund. Expense ratios can be found in every fund's prospectus and on numerous financial websites. The annual maintenance charge levied by mutual funds to pay their expenses is known as the expense ratio. It covers the fund's annual running expenditures, including as management fees, allocation charges, and promotional costs. The value of an expense ratio is determined by the mutual fund's size. A fund with a smaller pool of financial resources must devote a percentage of its resources to effective management. As a result, the relative worth of the expenses in relation to the overall amount of funds available rises.

Key words: Mutual fund, SEBI, Expense ratio, Direct and Regular mutual fund schemes.

Introduction:

Expense ratio is the fee that mutual funds charge to manage your money, much like a physician who charges a fee for his service. Based on the type of fund, the expense ratio may vary and simply put, it is the expense involved in operating a mutual fund. The highest chunk of the operating expenses goes towards the fee of the fund manager or advisor while the rest is distributed towards costs of custodial services, legal services, registrar fees, recordkeeping, accounting and auditing fees, etc. Some operating expenses may also include marketing costs. Since expense ratio is deducted from your investment daily following which the Net Asset Value (NAV) is published, you do not feel the pinch but if you are considering long-term gains (for a period of more than 5 years), it can make a lot of difference in your investment returns. As per the regulations issued by the Securities and Exchange Board of India (SEBI), the expense ratio of an equity fund cannot exceed 2.5% while for a debt fund, the maximum limit is 2.25%.

Concept of Expense ratio in Mutual fund:

The expense ratio of a [mutual fund scheme](#) refers to the annual fee charged by a mutual fund house to the investors for the management of the scheme. It is calculated by dividing a mutual fund scheme's total expense by the value of assets under its management ([AUM](#)). While managing a scheme, a fund house incurs expenses such as administrative cost, marketing cost, promotion cost, distribution cost, compliance costs, shareholder service cost, etc., which get reflected in the scheme's expense ratio.

An expense ratio reveals the amount that an investment company charges investors to manage an investment portfolio, a mutual fund, or an exchange-traded fund (ETF). The ratio represents all of the management fees and operating costs of the fund. The expense ratio is calculated by dividing a mutual fund's operating expenses by the average total dollar value of all the assets in the fund. Expense ratios are listed on the prospectus of every fund and on many financial websites.

Factors Affecting Expense Ratios

Expenses can vary significantly between types of funds. The category of investments, the strategy for investing, and the size of the fund can all affect the expense ratio. A fund with a smaller amount of assets usually has a higher expense ratio due to its limited fund base for covering costs. International funds can have high operational expenses because they may require staffing in several countries. Large-cap funds, with an average expense ratio of 1.25%, are typically less expensive than small-cap funds, which average 1.4%.

Review of literature:

PRITAM P. KOTHARI & SHIVGANGA C. MINDARGI, made an attempt to know investors attitude towards mutual fund investment and they had mentioned the considering factors which they need to concentrate while investing in mutual fund. Mutual funds offer professional management to investors, but at a cost. Typically, funds will charge a variety of fees that reduce the overall payout. Fees in mutual funds are divided into two categories: shareholder fees and annual operating fees. Shareholder fees, which take the form of loads and redemption fees, are paid directly by shareholders who buy or sell funds. Annual fund operating fees are charged as a percentage of the fund's assets, typically ranging from 1-3 percent. These fees are levied on mutual fund investors regardless of the fund's performance. As you might expect, in years when the fund loses money, these fees only serve to amplify losses.

Shivangi Agarwal, Nawazish Mirza Expense ratios are also important performance indicators because they may eat away at some of the fund's returns. An expense ratio is a measure that shows how efficient returns are above and beyond what investors pay for management fees. Table 6 shows the highest expense ratios for our sample funds.

Objectives:

1. To know the importance of expense ratio on mutual fund investment
2. To know different components involved in mutual fund expense ratio
3. To evaluate the impact of expense ratio on direct and regular plan of mutual fund investment schemes
4. To evaluate whether fund expense ratio reduces the return of mutual fund investment

Need for the study:

The Mutual Fund is a trust that pools the assets of several investors who share a common financial goal. The proceeds are then invested in stock market instruments such as stocks, bonds, and other securities. The profits made by these the company's investments and capital appreciation will be shared by its unit holders. proportional to the number of units they own as a result, the mutual fund is the most popular, it is an acceptable investment for the average person because it provides an opportunity to invest. Simultaneously, the investor should be aware of the entire expense

ratio associated with mutual fund investments, as well as if it affects returns depending on their investments and the impact of expense ratio on mutual fund investments.

Importance of Expense Ratio:

A mutual fund's [expense ratio](#) is very important to investors because fund operating and management fees can have a large impact on net profitability. The expense ratio for a fund is calculated by dividing the total dollar value of fund assets by the total amount of fund fees both management fees and operating expenses—charged to investors in the fund. Expense ratios for mutual funds vary widely. Expense ratios for [index funds](#) are significantly lower than for actively managed portfolio funds, averaging 0.06% in 2020. Expense ratios for actively managed funds averaged 0.71% in 2020, but some funds have much higher expense ratios.

Most investors do not realize the significant impact of a seemingly small percentage difference in [mutual fund](#) expense ratios, but an example easily demonstrates that even a relatively small difference has a significant effect on net investment profits.

It helps ascertain how much an investor will pay to a fund house:

Expense ratio allows investors to gauge how much money they have spent on fund management. Notably, a fund's expense ratio increases in a proportion equivalent to the increase in the investment value. Gaining an insight into this idea can help investors determine beforehand what to expect when their investment increases or decreases.

It helps decide the merit of direct plans:

Usually, direct plans accompany a lower expense ratio than regular plans. This is primarily because of the absence of any third-party involvement in the investment process. In turn, it helps to choose a more cost-effective alternative. However, investors must also factor in other crucial details of the fund like its performance and risk-reward profile before deciding the merit of the funds in question.

Helps to understand the impact on returns:

Higher expense ratio eats into investors' returns on investment. Hence, finding out about it beforehand helps determine how much of their returns on investment will erode in the long run. This helps to align investment goals with their choice of investment instrument and streamline the overall process better.

COMPONENTS OF THE EXPENSE RATIO:

As mentioned above, the TER accounts for several services to ensure the smooth operation of [mutual funds](#).

Management Fees

The asset manager and his team offer continued service and efforts to maximise the profits on your investment. Management Fee is the payment made to your [fund house](#) in exchange for their professional expertise for managing your mutual funds. Usually, between 0.5% - 1.0%, this component forms a significant portion of the expense ratio.

12B-1 Fee

A fund house follows marketing and promotional activities to expand its asset base. 12B01 fee represents the expenses incurred for promoting the mutual fund.

Maintenance or Administrative Fees

Managing your mutual fund requires routine operational tasks like record-keeping, customer support, etc. All these regular activities contribute to the maintenance or administrative fees charged by the fund house.

Brokerage Fees

When you opt for a mutual fund, you can either purchase it directly from the AMC or through a broker. The brokerage fee is the expenses incurred by the AMC to hire a broker to process the transactions during the purchase and sale of mutual funds.

Data Analysis and Interpretation:

SEBI Limit on Mutual Funds Expense Ratio:

The Securities and Exchange Board of India (SEBI) regulates the mutual funds managed by an AMC. An AMC must comply with the limits on TER as per the Regulation 52 of the SEBI Mutual Fund Regulations as tabulated below:

Weekly Net Asset on Equity Schemes (in Crores)	Maximum TER Allowed
0-100	2.5%
100-400	2.25%
400-700	2%
Above 700	1.75%

For debt schemes, SEBI lowers the maximum TER by 0.25% than [equity funds](#) in their respective slabs. And, to increase the reach of mutual funds in tier-2 and tier-3 cities, SEBI allows AMC to charge more by up to 30 basis points (0.3%).

SEBI Regulations on Expense Ratio

As per the capital market regulator, SEBI (Securities and Exchange Board of India), fund houses can charge Total Expense Ratio (TER), subject to the following maximum limits:

Asset Under Management (crores)	TER for equity-oriented schemes (%)	TER for other schemes excluding Index Funds, ETFs and Fund of Funds (%)
Rs. 0-500	2.25	2.00
Rs. 500-750	2.00	1.75
Rs. 750-2,000	1.75	1.50
Rs. 2,000-5,000	1.60	1.35
Rs. 5,000-10,000	1.50	1.25
Rs. 10,000-50,000	For every increase of 5,000 crores in AUM TER reduces by 0.05%	For every increase of 5,000 crores in AUM TER reduces by 0.05%
> Rs. 50,000	1.05	0.80

Expense Ratio is inversely related to the AUM of the fund. When the value of a funds' assets is small, the expense ratio is higher such that the management meets the fund expenses from a smaller asset base. Whereas, when the asset value of a fund is huge, the expense ratio is comparatively lower as the expenses get distributed across a wider asset base.

However, SEBI allows fund houses an extra of 30 basis points (0.30%) in expense ratio over and above the mentioned maximum limits for selling in beyond top 30 cities, only if 30% or more of new inflows come from beyond the top 30 cities. This is done to widen the penetration of the mutual funds in tier 2 and tier 3 cities.

Fund houses are also allowed to charge 5 basis points (0.05%) of AUM over and above the maximum expense ratio limits instead of an exit fee, wherein exit load is levied or is applicable. However, AMC's are not allowed to charge the expense ratio instead of exit load for close-ended schemes.

Role of Expense Ratio in Returns

Expense ratio shows what fraction of your returns goes into the pockets of your asset manager. For example, if you invest Rs. 1 Lakh in a mutual fund with an expense ratio of 1%, you must pay Rs. 1000 to your fund house for managing your mutual funds. If your mutual fund grows by 13%, you will receive 12% returns after deducting 1% as the expense ratio.

Lower Expense Ratio Vs. Higher Expense Ratio:

Just as buying the cheapest mobile is not always the best option, the same logic applies to mutual funds as well. On the onset, it would appear that a lower expense ratio means more profit and vice-versa. However, a higher expense ratio merely means that you pay more to your asset manager, and does not

necessarily mean lower returns on your investment.

You must understand that the returns on your investment depend upon how wisely your fund manager picks stocks. If an AMC generates higher yields on your mutual funds, it can easily compensate for the higher TER.

SEBI limit on TER:

The Securities and Exchange Board of India (SEBI) has defined certain limitations on the TER that a mutual fund can charge an investor. These are covered under Regulation 52 of SEBI Mutual Fund Regulations. Effective April 1, 2020 the TER of various categories stand revised and which are as follows.

1. TER on Equity funds

For equity schemes that are actively managed, the regulation permits a maximum TER of 2.25 % for the first Rs.500 crore of net assets averaged daily net assets.

TER limit applicable per AUM slab as per below,

on the first Rs. 500 crores	2.25%
on the next Rs. 250 crores	2.00%
on the next Rs. 1,250 crores	1.75%
on the next Rs. 3,000 crores	1.60%
on the next Rs. 5,000 crores	1.50%
On the next Rs. 40,000 crores	Total expense ratio reduction of 0.05% for every increase of Rs.5,000 crores of daily net assets or part thereof.
Above Rs. 50,000 crores	1.05%

2. TER on Debt funds

The limit for debt fund is 2.00%. and the TER limit per AUM slab is applicable as per below,

on the first Rs. 500 crores	2.00%
on the next Rs. 250 crores	1.75%
on the next Rs. 1,250 crores	1.50%
on the next Rs. 3,000 crores	1.35%
on the next Rs. 5,000 crores	1.25%
On the next Rs. 40,000 crores	Total expense ratio reduction of 0.05% for every increase of Rs.5,000 crores of daily net assets or part thereof.
Above Rs. 50,000 crores	0.80%

3. In addition to the above, the following costs or expenses may be charged to the Schemes,

1. Expenses in case of inflows from retail investors from cities beyond Top 30 cities charged proportionately under Regulation 52(6A) (b)
2. Additional expenses permissible under Regulation 52(6A) (c) towards various permissible expenses with scheme charging exit load.

Expense ratios charged by an asset management company on their mutual funds are subject to certain restrictions imposed by the Securities and Exchange Board of India (SEBI), to protect the interests of investors. This ensures a substantial flow of financial resources to capital market of the country.

The rules are different for [Exchange Traded Funds](#) and [Index Funds](#). For an initial asset base of Rs. 500 Crore of such a fund, a maximum total expense ratio of 2% is levied. For next Rs. 250 Crore, if any, a ratio of 1.75% is imposed, while any asset base higher than that is processed at 1.5% respectively.

Under Section 52 of the SEBI Mutual Fund Regulations, an asset management company can charge a maximum of 2.5% as the total expense ratio for the first Rs. 100 Crore of the portfolio value. For subsequent asset value of Rs. 300 Crore, a rate of maximum 2.25% is deductible, while 2% can be charged on subsequent slabs concerned with the rest of asset value.

MF direct plans vs regular plans – Expense ratios:

A Direct plan is what you buy directly from the mutual fund company (usually from their own website). Whereas a Regular plan is what you buy through an advisor, broker, or distributor (intermediary). In a regular plan, the mutual fund company pays a commission to the intermediary. This is then recovered as an expense from the plan. In mutual funds speak, the expense ratio is higher for a regular plan. Read along to understand Regular Vs Direct Mutual Funds in detail.

Direct Mutual Funds:

Direct Mutual Fund is the type of mutual [fund](#) that is directly offered by the [AMC](#) or fund house. In other words, there is no involvement of third-party agents – brokers or [distributors](#). Since there are no third-party agents involved, there are no commissions and brokerage. Hence the expense ratio of a direct mutual fund is lower. Thus, the return is higher due to a lower expense ratio. The direct plan of a mutual fund can be easily identified; the word ‘Direct’ is prefixed in the name of the fund. These [mutual funds](#) can be bought through either online or offline mode.

Regular Mutual Funds:

Regular plans are those mutual fund plans that are bought through an intermediary. These intermediaries can be brokers, advisors, or distributors. The intermediaries charge the fund house a certain fee for selling their mutual funds. The AMCs usually recover this fee through expense ratio. The expense ratio for regular mutual funds is slightly higher than direct mutual funds. Hence the returns tend to be a little higher for direct plans. A regular plan best suits investors who do not have the knowledge about the market nor the time to monitor their portfolio. Therefore, a regular plan is far more convenient for investors who aren't well informed about the market. They receive expert advice at a nominal fee.

The Difference Between Regular and Direct Mutual Fund:

In 2012, [SEBI](#) introduced the direct plans in Mutual Funds. This was to enable investors to buy mutual funds without any intermediary in between. Both the options – direct plan and regular plan are managed by the same mutual fund manager. They invest in the same assets as well. However, the major difference is that in a regular plan, the fund house pays commission as a distribution fee. While in the direct plan, there is no such commission or fee.

Below is the table showing the major differences for regular plan vs direct plan:

From the above Regular vs Direct mutual funds comparison, regular mutual funds are best suited for investors who seek financial advice. Even though regular plans seem costly when compared to direct mutual funds. The small percentage of the additional cost is worth the right investment decision. Therefore, compared to an uninformed wrong decision, well- researched advice can earn higher value.

Parameter	Direct Plan	Regular Plan
Third-Party	Not Present	Present
Returns	High (no additional fees to broker/agent)	Low
Expense Ratio	Low expense ratio (no additional fees to broker/agent)	High expense ratio
NAV	High	Low
Market Research	Done by Self	Provided by adviser
Investment Advice	Not Available	Available

Impact of Expense Ratio on Returns

The expense ratio of a fund helps to understand how much an investor will have to shell out to get their investment portfolio managed by professionals. Investors have to pay an expense ratio till the time they are invested in a specific mutual fund. Hence, a high expense ratio impacts returns on investment negatively. In the long run, this can erode investors' potential earnings. Consequently, investing in mutual funds with a low expense ratio can aid in maximizing returns. Based on this operating fee, one can easily decide whether or not the mutual fund will be a lucrative investment instrument. Since the investment market is subject to risks, it is crucial for investors to proceed cautiously. But typically, choosing a low-cost index fund can help maximize one's portfolio value. For instance, [NAVI Nifty 50 Index Fund](#) scheme comes with an expense ratio of 0.06%. The low expense ratio can prove helpful in protecting returns from lowering.

Expense ratio is a measure of what it costs an investment company to operate a mutual fund. This is expressed as a ratio of your overall investments with the fund. The largest component of the expense ratio is the fees paid for managing your money. For example, if you invest Rs 10,000 in a fund with an expense ratio of 1.5 percent, then you are paying the fund Rs 150 per year to manage your money.

Every fund house charges different expense ratios for different schemes. Regardless of the scheme performance, the fund house charges you that expense ratio. Therefore, it makes complete sense to go for funds with lower expense ratios. Although low expense ratio is not just the only thing one must look for in a good fund. The fund philosophy also matters, a fund house focused on costs may lower expense ratio on matter of principle, a fund house wanting more AUM may drop expense ratios for a completely different reason.

In case of [large-cap mutual funds](#), on the other hand, the amount reserved to meet the expenses is a smaller subject to the total asset value. Therefore, expense ratios have an inverse relationship with size of the respective mutual fund. This can be depicted by the expense ratio formula, given by total expenses divided by total assets of the funds. Higher the asset base, lower will be the ratio, and vice-versa, given total costs remain constant.

Conclusion:

Expense ratios are usually deducted from total revenue generated by a mutual fund, before disbursing it to the investors. Higher expense ratios imply a higher proportion of the returns being removed, thereby providing lower returns on investments. Since expense ratios levy a burden on annual returns earned, an investor should carefully analyse the same while choosing a mutual fund scheme to invest.

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