

Direct Stocks Vs Mutual Funds

"Should I invest in stocks directly or through equity mutual funds? Which of the two can generate better returns?" A participant asked in one of my investment seminars. This is not the first time that one has faced this question. This question keeps cropping up periodically.

There are quite a few investors who think they can easily generate higher returns than most mutual fund managers. Many also quote some of their successful stock picks. Such examples could be quite attractive and seductive sometimes. The result being, some individuals start thinking that beating other investors is quite easy. When one sees someone making money (or hears about such a story), the above question is raised.

What should one do? The question is straight forward, and so is the answer. One has to go back and understand what a mutual fund really is. A mutual fund is an investment vehicle offered by an asset management company. An investor investing in a mutual fund is outsourcing the activities related to investment management to a professional fund management and administration team. This professional fund management team takes up certain tasks on behalf of the investor, e.g. analyzing and identifying for investment opportunities, managing the inflows and outflows in the fund, taking care of investment administrative activities, valuation of the portfolio and calculation of the NAV, etc.

If an investor has to do all these activities, one would need three things, viz. (1) skills and abilities to manage money, (2) time required for various activities including investment research and administration, and (3) liking for all these activities. In the absence of one out of the first two, the performance could turn out to be disastrous. Investment management is a full time job and requires one to devote time towards study of balance sheets of companies to understand the businesses one is buying. It is surprising that so many investors buy stocks of companies without knowing the business of a company. Let us understand that one becomes part owner of a company by buying stocks. The owner of a company is entitled to profits of the company in proportion of the shareholding. If one is looking at becoming shareholder of a company with this understanding, it is important to buy stocks of companies that can remain profitable for long. In order to understand whether a company would be profitable or not for long, there is only one way – study the business of the company.

During one such discussion, one gentleman looking for buying stocks asked, "How many people know how to read a balance sheet of a company?" His question is right. However, there is a bigger danger if one really understands what is happening. Anyone looking for buying stocks should read the balance sheet. However, if one does not know how to read one, is trying to invest one's hard-earned money without realizing where the money is going. Isn't that a bigger danger?

Well, in the absence of abilities one would be better off taking professional help. This is where mutual funds come on. Very often, we tend to look at things, which are less important and ignore things that matter the most. In the question of managing money, whether direct investment in stocks would be more rewarding than investing through mutual funds, one often misses out the amount of time and effort one has to put in. there could be better utilization of one's own time – spending time with the family, pursuing some hobbies, etc.