

CHAPTER-1

MUTUAL FUNDS

1.1 Introduction

There are many investment avenues available in the financial market for an investor. Investors can invest in bank deposits, corporate debentures and bonds, post office saving schemes etc. where, there is low risk together with low return. They may invest in stock of companies where the risk is high and sometimes the returns are also proportionately high.

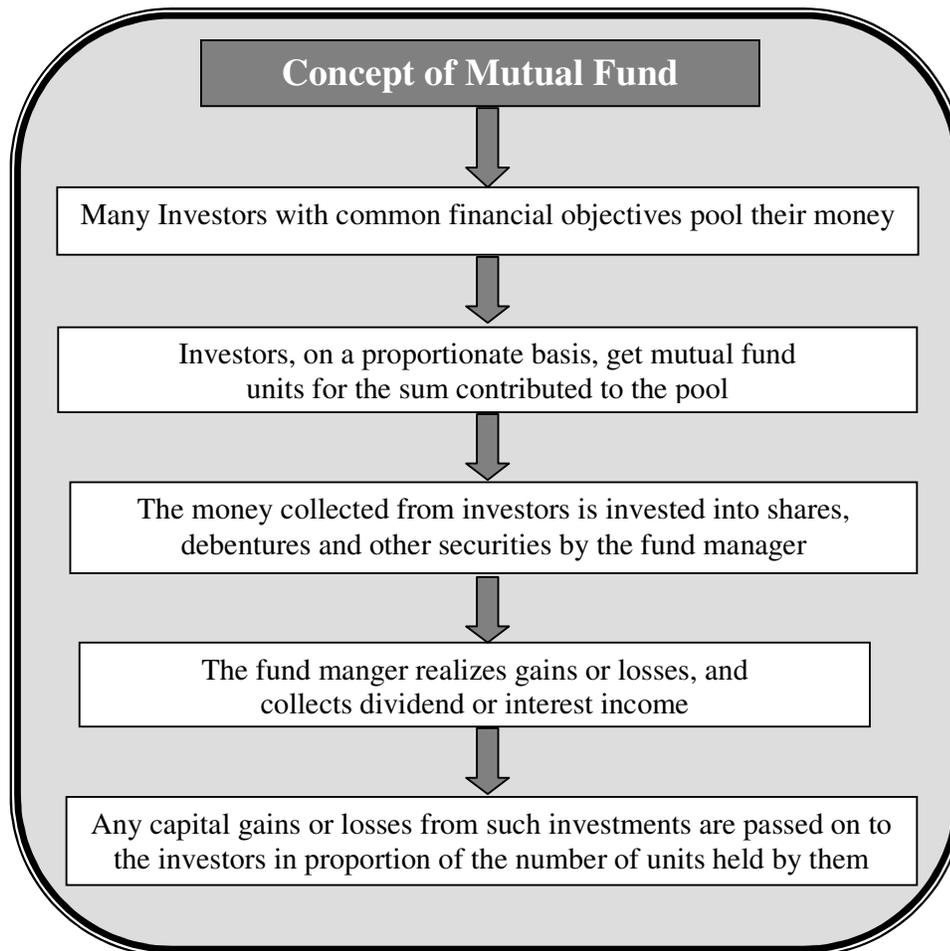
For retail investors, who do not have the time and expertise to analyze and invest in stock, Mutual Funds is a viable investment alternative. This is because Mutual Funds provide the benefit of cheap access to expensive stocks.

A Mutual Fund is a collective investment vehicle formed with the specific objective of raising money from a large number of individuals and investing it according to a pre-specified objective, with the benefits accrued to be shared among the investors on a pro-rata basis in proportion to their investment.

According to Encyclopedia Americana, “Mutual funds are open end investment companies that invest shareholders’ money in portfolio or securities. They are open ended in that they normally offer new shares to the public on a continuing basis and promise to redeem outstanding shares on any business day.”

According to Securities and Exchange Board of India Regulations, 1996 a mutual fund means “a fund established in the form of trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments”.

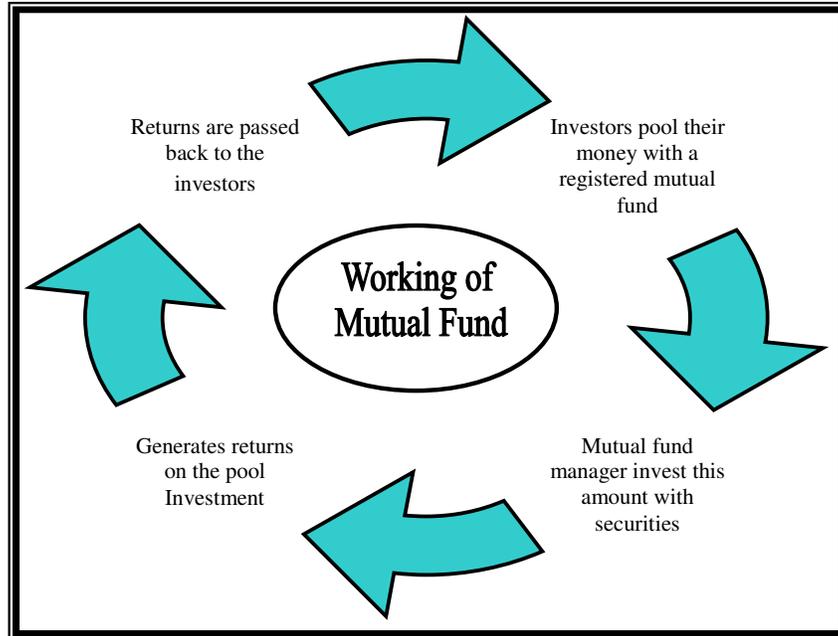
1.2 Concept of Mutual Fund



A Mutual Fund is a trust registered with the Securities and Exchange Board of India (SEBI) which pools up the money from individual/corporate investors and invests the same on behalf of the investors/units holders, in equity shares, government securities, bonds, call money market etc. The income earned through these investments and the capital appreciations realized are shared by its unit holders in proportion to the number of units owned by them. This pooled income is professionally managed on behalf the unit-holders, and each investor holds a proportion of the portfolio.

1.2.1 Operational flow of Mutual Fund

The following diagram depicts the operational flow of Mutual Fund



1.3 Parties to Mutual fund

The following diagram illustrates various entities involve in organizational structure of mutual fund:



1.3.1 Investors

Every investor, given his/her financial position and personal disposition, has a certain inclination to take risk. The hypothesis is that by taking an incremental risk, it would be possible for the investor to earn an incremental return.

Mutual fund is a solution for investors who lack the time, the inclination or the skills to actively manage their investment risk in individual securities. They delegate this role to the mutual fund, while retaining the right and the obligation to monitor their investments in the scheme.

In the absence of a mutual fund option, the money of such “passive” investors would lie either in bank deposits or other ‘safe’ investment options, thus depriving them of the possibility of earning a better return. Investing through a mutual fund would make economic sense for an investor if his/her investment, over medium to long term, fetches a return that is higher than what would otherwise have earned by investing directly.

1.3.2 Sponsors

Sponsor is the company, which sets up the Mutual Fund as per the provisions laid down by the Securities and Exchange Board of India (SEBI). SEBI mainly fixes the criteria of sponsors based on sufficient experience, net worth, and past track record.

1.3.3 Asset Management Company (AMC)

The AMC manages the funds of the various schemes and employs a large number of professionals for investment, research and agent servicing. The AMC also comes out with new schemes periodically. It plays a key role in the running of mutual fund and operates under the supervision and guidance of the trustees. An AMC’s income comes from the management fees, it charges for the schemes it manages. The management fees, is calculated as a percentage of net assets managed.

An AMC has to employ people and bear all the establishment costs that are related to its activity, such as for the premises, furniture, computers and other assets, etc. So long as the income through management fees covers its expenses, an AMC is economically viable. SEBI has issued the following guidelines for the formation of AMCs:

- a) An AMC should be headed by an independent non-interested and non-executive chairman.
- b) The managing director and other executive staff should be full-time employees of AMC.
- c) Fifty per cent of the board of trustees of AMC should be outside directors who are not in any way connected with the bank.
- d) The board of directors shall not be entitled to any remuneration other than the sitting fees.
- e) The AMCs will not be permitted to conduct other activities such as merchant banking or issue management.

1.3.4 Trustees

Trustees are an important link in the working of any mutual fund. They are responsible for ensuring that investors' interests in a scheme are taken care of properly. They do this by a constant monitoring of the operations of the various schemes. In return for their services, they are paid trustee fees, which are normally charged to the scheme.

1.3.5 Distributors

Distributors earn a commission for bringing investors into the schemes of a mutual fund. This commission is an expense for the scheme. Depending on the financial and physical resources at their disposal, the distributors could be:

- a) Tier 1 distributors who have their own or franchised network reaching out to investors all across the country; or

- b) Tier 2 distributors who are generally regional players with some reach within their region; or
- c) Tier 3 distributors who are small and marginal players with limited reach.

The distributors earn a commission from the AMC.

1.3.6 Registrars

An investor's holding in mutual fund schemes is typically tracked by the schemes' Registrar and Transfer Agent (R & T). Some AMCs prefer to handle this role on their own instead of appointing R & T. The Registrar or the AMC as the case may be maintains an account of the investors' investments and disinvestments from the schemes. Requests to invest more money into a scheme or to redeem money against existing investments in a scheme are processed by the R & T.

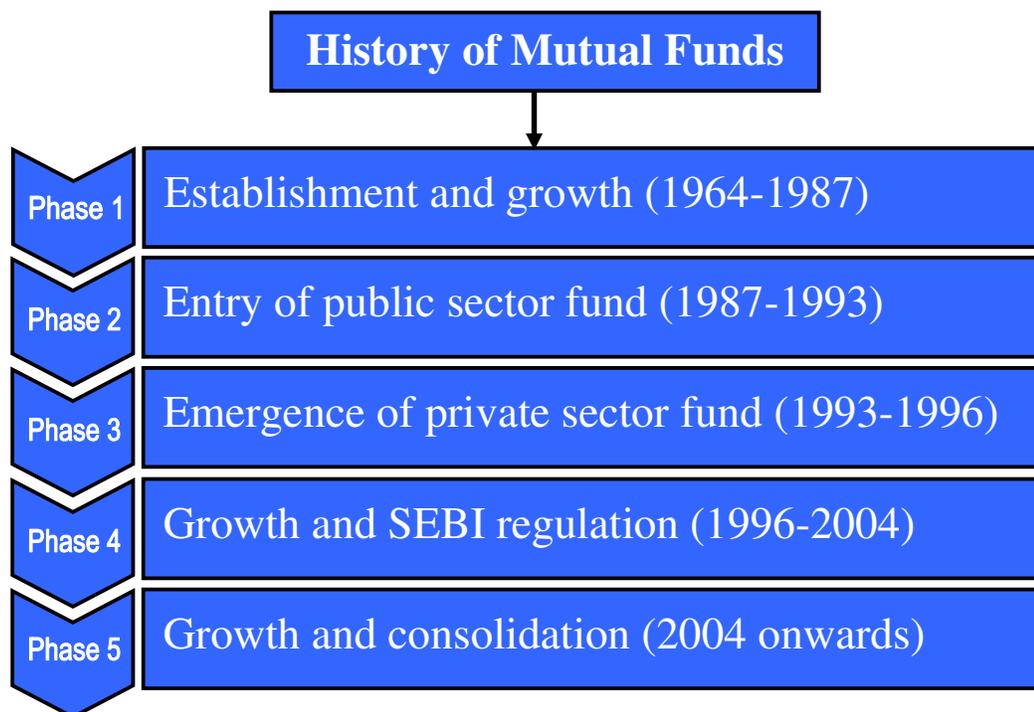
1.3.7 Custodian/Depository

The custodian maintains custody of the securities in which the scheme invests. This ensures an ongoing independent record of the investments of the scheme. The custodian also follows up on various corporate actions, such as rights, bonus and dividends declared by investee companies. At present, when the securities are being dematerialized, the role of the depository for such independent record of investments is growing. No custodian in which the sponsor or its associates hold 50 percent or more of the voting rights of the share capital of the custodian or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company.

1.4 History and Growth of Mutual Fund Industry

Growth of Mutual Fund

The Mutual Fund industry in India started in 1963 with the formation of Unit Trust of India at the initiative of the Government of India and Reserve Bank. The primary objective at that time was to attract small investors and it was made possible through the collective efforts of the Government of India and Reserve Bank of India. The history of Mutual Fund in India can be divided into five Phases.



Phase I: Establishment and growth of Unit trust of India 1964-1987

Unit Trust of India (UTI) was established in 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and it continued to operate under the regulatory control of the RBI until the two were de-linked in 1978 and the entire control was transferred in the hands of Industrial Development Bank of India. (IDBI). UTI launched its first scheme in 1964 named as Unit Scheme 1964 (US-64) which attracted the largest number of investors in any single investment scheme over the years. UTI launched more innovative schemes in 1970's and 80's to suit

the need of different investors. It launched ULIP (Unit Linked Investment plan) scheme in 1971. Six more schemes between 1981-84 children's gift growth fund and India fund in 1986 (India's first off scheme fund) master share (India's first equity dividend scheme) (1987) and monthly income schemes during 1990's. By the end of 1987, UTI had launched 20 schemes mobilizing net resources amounting to Rs.4564.0 crores. For these 23 long years up to 1964-87, UTI enjoyed complete monopoly.

Phase II: Entry of public sector Funds (1987-1993)

It was in 1986 that the Government of India amended banking regulations and allowed commercial banks in the public sector to set up Mutual Funds. This led to promotion of "SBI Mutual Fund" by State Bank of India in July 1987 followed by Canara Bank, Indian Bank, Bank of Baroda, Bank of India, Punjab National Bank, and GIC Mutual Fund.

The Indian Mutual Fund industry witnessed a number of public sector players entering the market in the year 1987. The Government of India further granted permission to Insurance corporations in the public sector to float Mutual Funds. The year 1987 marked the entry of non - UTI, public sector Mutual Fund set up by public sector bank, Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). The assets under management of the industry increased seven times to Rs.47004 crores. However UTI remained the leader with about 60% market share. The period of 1987 – 1993 can be termed as the period of public sector Mutual Funds. From a single player in 1985, the number increased to 8 players in 1993.

Phase III: Emergence of private sector funds (1993 – 1996)

The permission was given to the private sector funds including foreign funds management companies (most of them entering through joint venture with Indian promoter) to enter the Mutual Fund industry in 1993. With the entry of private sector funds in 1993, a new era started in Indian Mutual Fund industry, giving the Indian investors a wider choice of fund and therefore giving rise to more competition in the industry. Private funds introduced innovative products, investment techniques and investors servicing technology during 1994. In 1993 the first Mutual Fund regulation came into being under which all Mutual Funds, except UTI was to be registered. The Kothari Pioneer (now merged with Franklin Templeton) was the first private sector Mutual Fund registered in July 1993. The number of Mutual Fund houses went on increasing with many foreign Mutual Funds setting up funds in India and also the industry witnessed several mergers and acquisitions.

Phase IV: Growth and SEBI Regulation (1996 – 2004)

The Mutual Fund industry witnessed robust growth and strict regulations from SEBI after 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in Mutual Funds.

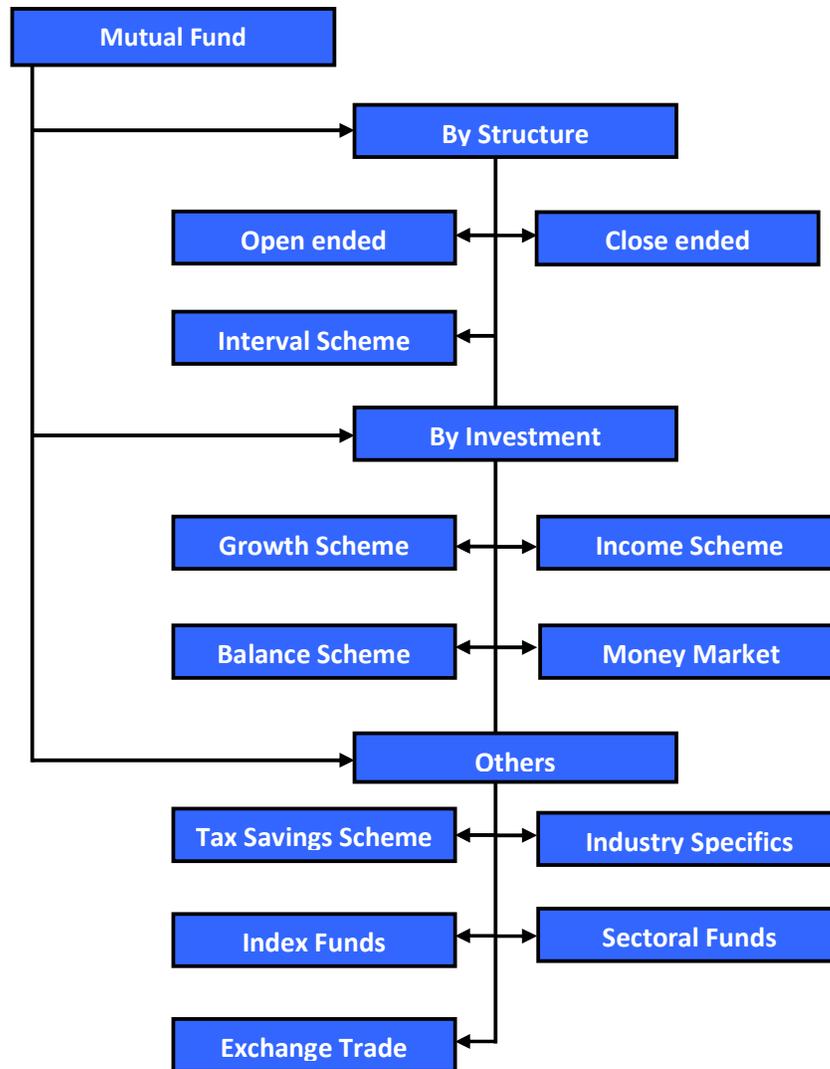
Investors' interests were safe guarded by SEBI and the government offered tax benefit to the investors. In order to encourage them, SEBI (Mutual Funds) Regulations 1996 was introduced by SEBI that set uniform standards. The union budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various investor awareness programmers were launched during this phase both by SEBI and Association of Mutual Fund in India (AMFI).

Phase V: Growth and Consolidation (2004 onwards)

The industry witnessed several mergers and acquisition. Recent examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, etc. Simultaneously more international Mutual Fund players entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. At the end of December 2006, there were 32 funds which managed assets of Rs.323597 crores under 75 schemes as compared to assets worth Rs.47000 crores under management in March 1998. Assets under Management of mutual funds (in all scheme) from April 2007 to December 2007 was Rs 542794.36 crores. This does not include Net Assets of Rs.7141077 crores under exchange trade funds (ETF). (Source: Report of Investment Management Department, SEBI) Besides, low interest rate, tax holidays on some schemes, excellent performance of the stock market has contributed to the growth of Mutual Fund. But the penetration of Mutual Fund in the retail investors segment is still low at 6% of GDP against 70% in US. Active participation of the retail investor will further boost the Mutual Fund industry in India. Today the industry is pre – dominantly urban and to some extent semi – urban. Mutual Fund industry must tap the huge untapped potential in the country.

1.5 Types of Mutual Fund Schemes

Mutual Fund schemes may be classified on the basis of its structure and investment objective.



1.5.1 Based on Structure:

1.5.1.1 Open-ended Funds

An open-ended fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices. The key feature of open-end schemes is liquidity.

1.5.1.2 Closed-ended Funds

A closed-ended fund has a stipulated maturity period which generally ranges from three to fifteen years. The fund is open for subscription only during a specified period. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where they are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the Mutual Fund through periodic repurchase at NAV related prices.

1.5.1.3 Interval Funds

Interval funds combine the features of open-ended and close-ended schemes. They are open for sale or redemption during pre-determined intervals at NAV related prices.

1.5.2 Based on Investment Objective:

1.5.2.1 Growth Funds

The aim of growth funds is to provide capital appreciation over medium to long- term. Such schemes normally invest a majority of their corpus in equities. Studies have shown that returns from stocks, have outperformed most other forms of investments held over long term. (Baruan Varuan(1991), Obaidulla and Sridhar (1991), Adhikari and Bhosale (1994), Gupta and Sehgal (1997), Sagar, Narayan R. and Madava, R. (2003), Rao, D. N. (2006)). Growth schemes are ideal for investors having a long-term outlook seeking growth over a period of time.

1.5.2.2 Income Funds

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures and Government securities. Income Funds are ideal for capital stability and regular income.

1.5.2.3 Balanced Funds

The aim of balanced funds is to provide both growth and regular income. Such schemes periodically distribute a part of their earning and invest both in equities and fixed income securities in the proportion indicated in their offer documents. In a rising stock market, the NAV of these schemes may not normally keep pace, or fall equally when the market falls. These are ideal for investors looking for a combination of income and moderate growth.

1.5.2.4 Money Market Funds

The aim of money market funds is to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money. Returns on these schemes may fluctuate depending upon the interest rates prevailing in the market. These are ideal for corporate and individual investors as a means to park their surplus funds for short periods.

1.5.3 Others :

1.5.3.1 Tax Saving

These schemes offer tax rebates to the investors under specific provisions of the Indian Income Tax laws as the Government offers tax incentives for investment in specified avenues. Investments made in Equity Linked Savings Schemes (ELSS) and Pension Schemes are allowed as deduction u/s 88 of the Income Tax Act, 1961. The Act also provides opportunities to investors to save capital gains u/s 54EA and 54EB by investing in Mutual Funds.

1.5.3.2 Sector Specific

Industry Specific Schemes invest only in the industries specified in the offer document. The investment of these funds is limited to specific industries like InfoTech, Fast Moving Consumer Goods (FMCG), and Pharmaceuticals etc.

1.5.3.3 Index

Index Funds attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE.

1.5.3.4 Sectoral

Sectoral Funds are those, which invest exclusively in a specified industry or a group of industries or various segments such as 'A' Group shares or initial public offerings.

1.5.3.5 Exchange Traded Funds

Exchange Traded Funds, (ETF) just like their index fund counterparts, also track indexes. The difference is that the stocks of individual companies that comprise a given index are bundled into an equity-like investment vehicle that is traded on an exchange, exactly like a stock. That means that those purchasing ETF shares can place orders for them throughout the day, and even use limit orders to make trades. Because they are traded on an exchange and share many of the attributes of individual equities, ETFs can also be shorted and offer underlying options as an investment opportunity.

1.6 Advantages of Mutual Funds

Mutual Funds are professionally managed companies or schemes that pool money from investors and invest it in stock markets, shares, derivative markets and other securities. By investing in Mutual funds, investors can avail of the following advantages:-

1.6.1 Professional Management

The investor avails of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

1.6.2 Diversification

Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. This diversification is achieved through a Mutual Fund.

1.6.3 Convenient Administration

Investing in a Mutual Fund reduces paperwork and helps to avoid many problems such as bad deliveries, delayed payments and follow up with brokers and companies. Mutual Funds save time and makes investing easy and convenient.

1.6.4 Return Potential

Over medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

1.6.5 Low Costs

Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because of the benefits of scale in brokerage, custodial and other fees which translate into lower costs for investors.

1.6.6 Liquidity

In open-end schemes, an investor can get his money back promptly at net asset value. With closed-ended schemes, an investor can sell his units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some closed-ended and interval schemes offer periodically.

1.6.7 Transparency

Regular information can be obtained by the investors on the value of investment in addition to disclosure on the specific investments made in the scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

1.6.8 Flexibility

Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, an investor can systematically invest or withdraw funds according to his needs and convenience.

1.6.9 Choice of Schemes

Mutual Funds offer a family of schemes to suit an investor's varying needs over a lifetime. For e.g. Growth schemes are ideal for investors having a long-term outlook seeking growth over a period of time. Income Funds are ideal for capital stability and regular income. Balanced Funds are ideal for investors looking for a combination of income and moderate growth. Money Market Funds are ideal for corporate and individual investors as a means to park their surplus funds for short periods.

1.6.10 Well Regulated

All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

1.6.11 Affordability

Mutual funds allow even small investors to indirectly reap the benefit of investment in shares of a big company because of its large corpus, which an individual investor may not be able to do so because of insufficient funds.

1.7 Limitations of Mutual Funds

Following are some of the limitations of mutual funds.

1.7.1 Tax issues

Although, the returns on investment are quite high, a mutual fund cannot guarantee lower tax bills. The tax amounts are usually high, especially in case of short-term gains.

1.7.2 Investor issues

A mutual fund requires a deep and long term analysis of the amount of investment and its potential investment areas. If the company fund manager changes regularly, it may adversely affect the returns on investment.

1.7.3 Fluctuating Returns

Mutual funds are like many other investments where there is always the possibility that the value of mutual fund will depreciate, unlike fixed income products, such as bonds and treasury bills, mutual funds experience price fluctuations along with the stocks that make up the fund.

1.7.4 Over Diversification

Although diversification is one of the keys to successful investing, many mutual fund investors tend to over diversify. The idea of diversification is to reduce the risks associated with holding a single security; over diversification occurs when investors acquire many funds that are highly related and, as a result, reduce benefits of diversification.

1.7.5 High Costs and Risks

Mutual funds provide investors with professional management, but it comes at a cost. Funds will typically have a range of different fees that reduce the overall payout. In mutual funds, the fees are classified into two categories: shareholder fees and annual operating fees. The

shareholder fees, in the forms of loads and redemption fees are paid directly by shareholders purchasing or selling the funds. The annual fund operating fees are charged as an annual percentage – usually ranging from 1-3%. These fees are assessed to mutual fund investors regardless of the performance of the fund. Mutual funds are subjected to market risks or assets risks. If the investment is not sufficiently diversified, it may involve huge losses.