CHAPTER

11 MUTUAL FUNDS

INTRODUCTION

Globally, mutual funds have long been a popular investment option. In the US, the assets under management (AUM) of mutual funds are more than 79 per cent of gross domestic product and 148 per cent of bank deposits as compared to a little above 12.28 per cent as 18.33 percent respectively. The difference indicates the enormous market potential in India. The India asset management industry is still at the nascent stages of growth when compared to developed countries. Mutual fund is a unique financial service of great importance. In the last 11 years between June 2000 and June 2011, the mutual fund industry has been growing at a healthy rate of more than 30 per cent.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1993 defines a mutual fund as "a fund established in the form of a trust by a sponsor to raise monies by the trustees through the sale of units to the public under one or more schemes, for investing in securities in accordance with these regulations."

The economic progress of a country is, to a certain extent, linked with the growth of the capital market. Capital market growth depends on the savings of the nation. In India, notwithstanding a high rate of savings by the community, the capital market is not in a position to grow fast because the common man has not acquired the necessary know-how himself to select appropriate avenues of investment which will serve his needs. Therefore, the savings are mainly directed towards bank deposits/real estate/gold, etc. If he is assured that there are organisations of repute which have necessary expertise to select appropriate avenues of investment where the yield is attractive enough, with utmost security of the capital invested, it would create a proper climate for diversion of a part of the savings which at present goes into sectors where there is either only capital appreciation but with little or no scope for regular periodical return on investment or no capital appreciation at all, but with a periodical small return on the investment.

In these circumstances, there is enough scope for Mutual Funds to operate, which would not only assure a reasonable capital appreciation on his investment but also provide a regular dividend at periodical intervals with also a facility for easy encashment of the principal.

This chapter analyses the growth of the mutual funds and their importance in the Indian Financial System.

EVOLUTION OF MUTUAL FUNDS

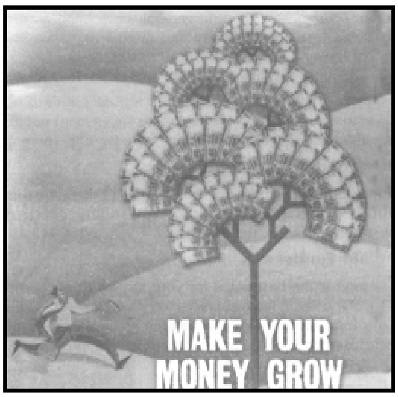
When an enterprising Dutch merchant Adriaan Van Ketwich set up what is now recognised as the world's first mutual fund in 1774, he fittingly called it Eendragt Maakt Magt (unity makes strength). And indeed, despite their chequered history, over two-and-a-half centuries mutual fund have been doing just that. Unfortunately, of course, much more recently, strength was not something that we could really attribute to the industry globally – as it was struggling to hold its ground amidst financial turbulence.

Historically, mutual fund investment traces its origins to the early pioneering investments of Scottish and English investors in the American West in the 1800s, and later of the early global portfolio investors in Japan in the 1960s.

The stockmarket is the best place for your money to make more money. But only if you start out with a lot of money in the first place, and if you understand financial manoeuvring. In 1822, royalty (in the form of King William I of the Netherlands) came up with an option for the rest of us. The closed-end fund. It was a stratlingly simple idea. A group of investors, individuals and institutions with common investment goals, pooled their investment and placed them with fund manages. These professional money managers then invested these funds in securities, and distributed the profits among the fund members. Rubert Fleming's first investment trust set up in the 1870s, promised to manage the finance of the moneyed classed of Scotland.

Fleming's Trust called Foreign and Colonial Investment Trust was formed as a limited company, to invest in a selection of 18 overseas Government Stocks, at an average yield of 8 per cent. The moneyed people latched on to the trust idea in a period of falling interest rates. The 'investment trust' concept spread rapidly through Europe, and the first American fund was created in 1893. The idea spread quickly around the world, but it came to India only in the 1960s.

WHAT IS A MUTUAL FUND?



Mutual Funds are financial intermediaries in the investment business. They collect funds from public and invest on behalf of the investors as "pass through entities" with losses and gains accruing to the investing only. Mutual funds sell their share to the investors, invest the proceeds in a wide choice of securities in the financial market. Owners of shares receive pro rata shares of the earnings from these assets, minus management and other fees assessed by the fund.

Mutual funds are defined by the different authors in different words meaning one and same thing, *i.e.,* it is a non-banking financial intermediary which acts as an important vehicle for bringing wealth holders and deficit units together indirectly. Mutual funds are pooling funds together and then investing that fund to different securities, thus reduce risk by diversification.

Mutual Fund units are investment vehicles that provide a means of participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully. On another level, they also provide a route into specialist markets where direct investment often demands both more time and more knowledge than an investor or his financial adviser may possess.

The basic idea is simple: a large number of investors pool their money in order to obtain a spread of professionally managed Stock Exchange investments that they cannot obtain individually. The advantage is that the investor in a mutual fund is taking much less of a risk than a direct equity investor, because increase in the number of stocks held obviously reduces the effect that any one stock can have on the overall performance of the equity portfolio. Professional management has two main benefits: it provides specialist investment expertise which should ensure greater success than the inexperienced investor can achieve on his own and it reduces the administrative burden of investment.

A mutual fund is divided into equal portfolios called units. The price of units is calculated regularly by the managers, rather than being determined by supply and demand in the market. The prices are quoted for units — the higher (offer) price being the price the investor pays to buy units, and the lower (bid) price being the price he will receive for units sold back to the managers.

Mutual funds issue units to investors in accordance with the quantum of money invested by them. The profits and losses are shared by investors in proportion to their investments. Mutual funds normally come out with a number of schemes with different investment objectives. A mutual fund must be registered with the Securities and Exchange Board of India (SEBI), which regulates the securities markets, before it can collect funds from the public.

Mutual fund managers are the only people allowed to make a market in Mutual Fund units, and they must be prepared to buy units from and sell units to the public at any time.

The price of the units in any mutual fund is governed by the value of the underlying securities. The price will therefore fluctuate with the movements of the market sector in which a fund is invested. The value of an investor's holding in a unit can therefore, like an investment in shares, go down as well as up.

A SMALL DROP

The Indian mutual fund industry with an AUM of ` 6.9 lakh crore ($16 billion currently accounts for just under 0.30 per cent of the global industry, which collectively manages assets valued at $56.8 trillion, Ironically, it is this minuscule size that is attracting international fund managers to set up shop in India. Low penetration and the huge potential for growth, given rising incomes and favourable demographics, are attracting them.

"Looking at a GDP growth upward of 8 per cent and companies posting earning between 15-20 per cent, I see the industry growing by at least 15 per cent on an average over the next five years," says S. Nagnath, President and CIO, DSP BlackRock Investment Managers India.

Several of the foreign fund houses including Franklin Templeton, Fidelity, JPM organ, BNP Paribas, ING, Amundi, Nomura, T Wore Price, HSBC, Principal, Pioneer and Deutsche Bank have built up a presence either on their own or partnering with local fund house. Glodman Sachs is the latest to joint the 45-member clud having bought over an existing fund, Bechmark.

It is this promising future which has led to companies like Unit Trust of India and Fidelity to invest steadily during the downturn. “It makes sense to build bunkers during winter” says Jaideep Bhattacharya chief marketing officer UTI, explaining that, during downturns, you get properties at lower cost, lease rentals are down and people are willing to ink long term leases, talent is also available at fairly decent values. Investments during such times help you to capitalise on opportunies when the tide starts turning he explains. UTI, which had a network of 60 branches in 2008, has expanded its presence to 150 branches in 2011.

MUTUAL FUND SET UP

A mutual fund is set up in the form of a trust, which has a sponsor, trustees, an asset management company (AMC) and a custodian. The trust is established by one or more sponsors, akin to the promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders.

The AMC (approved by SEBI) manages the funds by making investment in various securities. The custodian, who is registered with SEBI, holds the securities of the various schemes of the fund in its custody.

The trustees are vested with the general power of superintendence and direction over the AMC. They monitor the performance and compliance of SEBI regulations by the mutual fund.

SEBI regulations require that at least two-thirds of the direction of the trustee companies or board of trustees must be independent – they should not be associated with the sponsors. Also, 50 per cent of the directors of the AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.

TYPES OF MUTUAL FUND

No single gun is suitable for all types of hunting. Nor is one fishing rod suitable for all types of fishing. Similarly, no one mutual fund is suitable to the vast variety of investors’ needs and objectives. The needs and the risk-taking capacity of an old widow may differ significantly from those of a young businessman. In the funds market, many types of funds are offered to the investor. His choice of a fund will depend on what he wants his money to earn for him and how much risk he is willing to take. Most of the funds will fall in one of the following four categories:

(i) Open and Close-ended Funds

If the period and/or target amount of the fund is definite, the fund is called close-ended. If indefinite, it is called open-ended. For instance, the Unit Scheme (1964) of the Unit Trust of India (UTI) is an open-ended fund, both in terms of period as well as target amount.

A close-ended fund or scheme has a stipulated maturity period, for example 5-7 years. The fund is open for subscription only during a specified period at the time of launch of the scheme.

(ii) Income and Growth-oriented Fund

The income-oriented fund aims at distribution of income periodically amongst investors. Consequently, its Investment strategy conforms to the fund objective by deployment of investors' monies into fixed income yielding securities. On the other hand, the growth-oriented fund meets the investors' need for appreciation, high risk-bearing capacity and ability to defer liquidity. As such, the investment by growth-oriented funds are predominantly made in equities. The fund which partially meets the needs for income and growth are called 'balanced' or 'income-cum-growth' fund.

(iii) Area, Industry, Customer Group Funds

The funds may have, at the international level, investments in securities of specified areas, *e.g.,* Japan Fund, Thailand Fund or South Korea Fund, etc. These funds provide access to foreign investors into domestic securities of these countries. Similarly, certain funds may invest their resources in specified industry or industries like Rail Road or Petroleum Industry funds in the US. Certain mutual funds may be confined to a high-tech and high-growth industry, which may attract risk taken in such cases. The fund may also aim at a specific customer target group to meet their major needs, like funds for pensioners, widows, etc.

(iv) Taxation Funds

Certain funds are designed to avail certain tax-exemptions, whether in the domestic or foreign capital markets. Tax Saving Magnum of SBI Capital Markets Limited is an example of the domestic type. UTI's US $60 million India Fund, based in the US, is an example of the latter type off-shore mutual fund to avail the tax exempt status in tax havens.

(v) Income/Debt-oriented Scheme

The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities like bonds, corporate debentures, government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets.

However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of a change in interest rates in the country. If the interest rates fall, the NAVs are likely to increase in the short term and *vice versa*. However, long-term investors may not bother about these fluctuations.

(vi) Balanced Fund

The aim of balanced funds is to provide growth and regular income, as such schemes invest both in equities and fixed income securities in the proportion indicated in their offer documents. These are appropriate for investors looking for moderate growth. They generally invest 40 to 60 per cent in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.

(vii) Gold Exchange-traded Funds

(Gold ETFs) have made an entry into the Indian mutual fund market in 2005. Only five fund houses have offered this product and going by the assets under management (AUM) of these fund houses in terms of absolute values, these products are not yet popular. But there can be little doubt these products are destined to come into their own. All five gold ETFs in India showed a rise in collections with the total corpus up by over 10% compared to April 2008. The total gold collection was 4.57 tonnes at the May-end boosted by Akshaya Tritiya.

Gold ETF buyers are pure 'investors' who seek a return out of their investment without any other motivation such as beautification or social status or love of possessing physical gold. It is as specialised an investment in sectorial mutual funds such as in infotech or FMCG. In fact, it is even more specialised because an investor in infotech or FMCG holds a basket of investments in different IT or FMCG companies and is driven by the desire to invest in the 'IT industry' or 'FMCG industry'. In case of gold ETFs, the investment is not only not in an industry, it is not in a basket of products, it is only in one single product — gold. The commodity gold is the 'standard' gold bullion 0.995 purity. ETF topped the charts of mutual funds in terms of returns for May, 2008.

(viii) Real Estate Mutual Fund

The market regulator, the Securities and Exchange Board of India (SEBI), recently spelled out norms for the launch of real estate mutual funds (REMFs) in India, which would invest in real estate directly, or indirectly (through assets associated with, or benefiting from, the real estate sector). REMFs would be like any mutual fund, but with real estate and related securities as underlying assets.

The other schemes are:

(ix) Money Market or Liquid Fund

These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments like treasury bills, certificates of deposit, commercial paper, inter-bank call money and government securities. The returns on these schemes fluctuate mush less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

(x) Gift Fund

These funds invest exclusively in government securities, which have no default risk. The NAVs of these schemes also fluctuate because of change in interest rates and other economic factors as in the case of income or debt-oriented schemes.

(xi) Index Fund

Index funds replicate the portfolio of a particular index like the BSE sensitive index, S&P NSE 50 index (Nifty), etc. These schemes invest in securities in the same weightage comprising of an index. The NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to factors known as "tracking error". Necessary disclosures in this regard are made in the offer document of the mutual fund scheme.

There are also exchange traded index funds launched by the mutual funds, which are traded on the stock exchanges.

(xii) Commodity Funds

Commodity funds that invest in a single commodity or a group of commodities are called specialised commodity funds. Funds that invest in all commodities are called diversified commodity funds; these bear less risk than specialised commodity funds. Precious metal funds, gold funds, and gold exchange traded funds are examples of commodity funds.

A short overview of the types of mutual funds along with benefits of each is provided below.

Fund type	***Benefits***	***Downside/risk***	***Who should Invest?***
1. Growth funds	Capital appreciation in the medium to long-term. Invest in equities.	Higher volatility.	Investors having a long-term outlook seeking appreciation over a period of time.
2. Income funds	Less volatile. Provide steady return on investment. Invest in debt instruments like debentures, bonds, G-sec and the like.	Limited capital appreciation.	Investors seeking regular and steady return on investment.
3. Balanced funds	These funds provide the best of both world, *i.e.,* capital appreciation and regular income. Invest in both equities and debt instruments (typically a 40-60 ratio).		Investors seeking both regular income and capital appreciation.
4. Money market/ Liquid funds	Lowest fluctuation in liquid funds, fund schemes. Invest exclusively in safer short-term instruments such as inter-bank call money and G-sec.	No capital appreciation.	Investors looking to invest their surplus, returns amongst mutual funds for short periods of time and get some income on the same.
5. Tax saving funds	These funds offer tax savings in line with the provisions of the Income Tax Act. *E.g.,* ELSS (Equity Linked Savings Scheme).	They offer the same risk as equity linked funds.	Investors seeking specific tax rebates.
6. Index funds	These funds replicate indices like Sensex and Nifty *i.e.,* the portfolio of these funds has securities in the same weight as does the index it seeks to replicate. NAVs of these funds follow the rise and fall of the indices.		Investors who believe they can rely on the movement of indices like the Sensex.

7. Sector specific funds	These funds invest exclusively in companies in specific sectors like intrastructure, IT, oil and gas. Performance of theses funds depends on the performance of the equities of companies in that specific sector.	More risky compared to diversified funds. Need specific industry knowledge of specific companies.	Investors who want to invest only in specific sectors but who do not want to invest in equity.

THE ADVANTAGES OF INVESTING IN MUTUAL FUNDS:

The mutual fund industry has grown at a phenomenal rate during the last years. Between December 2004 and June 2008, assets under management of mutual funds increased by ` 4,14,062 crore to ` 5,64,599.28 crore. The mutual fund industry has been playing key role in the capital market. The advantage of investing in mutual funds arises for the following reasons:

1. ***Professional Management:*** You avail 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.
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. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.
3. ***Convenient Administration*:** Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual funds save your time and make investing easy and convenient.
4. ***Return Potential*:** Over a medium to long-term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.
5. ***Low Costs*:** Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.
6. ***Liquidity*:** In open-ended schemes, you can get your money back promptly at net asset value related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price or avail of the facility of direct repurchase at NAV related prices which some close-ended and interval schemes offer you periodically.
7. ***Transparency*:** You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager's investment strategy and outlook.

8. ***Flexibility:*** Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.
9. ***Choice of Schemes*:** Mutual Funds offer a family of schemes to suit your varying needs over a lifetime.
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.

OTHER ADVANTAGES ARE

1. Offering wide portfolio investment.
2. Providing better yields.
3. Providing research service.
4. Offering tax benefits.
5. Simplified record keeping.
6. Supporting capital market.
7. Promoting industrial development.
8. Reducing market cost.
9. Developing equity culture.
10. Keeping the money market active.

CHOOSING A FUND

The Investor may either directly choose a fund or if his portfolio is substantial, he may hand over this responsibility to an adviser. In either case, he has to be clear in his objectives: What does he want from the fund?

Before choosing a fund, the investor or his adviser should assess the performance of the fund. A good historical record, though not a guarantee for similar future trend, could, among other things remaining the same, be a better horse to bet on than new funds. Fund's overall performance in all schemes, rather than one or two schemes, will indicate its investment expertise.

Also worth looking at is a fund's consistency in beating the index representing the market in which it is invested. Yet another rule of thumb for the investor is that traditionally the stock market index and inflation rate have moved in unison. On the other hand, the interest rates and stock markets have moved in the opposite direction. The investor may, therefore, time his entry and exit into the fund market accordingly.

GOALS

Different goals may be set apart for each class of fund. Some may be income-oriented and some growth-oriented and some a combination of both. Depending upon the goal set for the fund, the nature of investment to be made is decided.

The units are sold or bought back on the basis of an offer price and a bid price. The former is the price at which the managers are prepared to sell the units and the latter is the price at which they are prepared to re-purchase them. The difference in prices would reflect the income accrued on the fund and the same belongs to the managers to give them a profit after they have met the associated cost, commission and the management expenses.

Where the demand for units exceeds the purchases, new units are created. Otherwise, some units are cancelled. This new creation or cancellation will involve adjustment to the Net Asset Value (NAV) which would take care of the expenses of acquiring or realising the investment. Any difference between this adjusted NAV and the offer and the bid prices accrues to the managers. The NAV will be worked out and published at regular intervals so as to enable the unitholders to know the growth of their investment in units.

DYANAMICS IN THE MUTUAL FUNDS

There are two fundamental dynamics in the Indian mutual fund industry.

- The trend towards open ended funds.
- Greater awareness among individual investors about how mutual funds work and the value they add.

The Nest-Eggs

Features	*Mutual Fund*	*Pension Scheme*	*Provident Fund*
Investor	Individual	Individual	Company
Objective	Variety of purposes	Retirement planning	Retirement planning
Time Horizon	Variable	Long-term	Long-term
Participation	Voluntary	Voluntary	Mandatory
Contribution to Fund	Initial investment	Regular payments	Regular payments
Exit	At will	Penalised	Penalised
Tax Concessions	None	None	Contributions tax-deductible
Fund Manager's Discretion	High	High	Limited
Investments	Debt + Equity	Debt	Debt

The rest are:

- The combined effect of these trends will result in more benefits.
- More money flowing into mutual funds as investors realise the futility and difficulty in direct primary and secondary market investments.
- The narrowing of the gap between the net asset value of many close ended funds and their market price, as the more educated investors seize this opportunity to buy funds trading at discounts.

- The emergence of a class of educated intermediaries who will sell mutual funds by taking on the role of financial planners/counsellers rather than mere purveyors / sellers of financial products.
- The start of a new industry in mutual fund rating agencies as investors look for an unbiased source of information on the performance of various funds.
- The professionalisation of the secondary market brokers as they cater to demands of savvy institutional investors.
- Creation of more sophisticated infrastructure such as custodians, depositories, screen-based confirmations, jumbo lots and inter-institutional trading.
- The emergence of industry specific funds as well as the launch of many more income and money market funds.

THE THREE FACTORS THAT WILL DRIVE THE MUTUAL FUND BUSINESS ARE

(*i*) ***The urge to merge*:** We are at the start up stage of a new industry with only a 39 participants today. Three years from now, there could be as many as 50 mutual funds. By 2012, however, the industry will witness consolidation with the bigger fish swallowing the smaller or the smaller players simply being muscled out of existence.

(*ii*) ***The issue of expenses*:** Mutual funds will see their margins squeezed as customers will become more sensitive to expenses and returns normalise in Indian equity markets to world levels. Other factors will contribute, such as the lower assets per fund family which will mean lower revenues, mounting expenses with the cost of marking and infrastructure becoming increasingly prohibitive.

(*iii*) ***Starting a family:*** Most of the larger and better known groups will start open ended mutual fund families such as the Kothari Pioneer and JM Mutual Fund. By offering various degrees of combination of growth and income and easy/free switching options, mutual funds will cover not only investors with different risk preferences, but also retain those whose needs and preferences change over time.

THE MUTUAL FUND INDUSTRY

Since their emergence as a financial instrument, the mutual funds had a difficult time convincing the investors. The reasons were mainly because of certain guidelines under which they were supposed to operate and secondly, it took some time for the investor to get familiar with a comparitively new investment option.

However, recent change in mutual funds regulations as approved by the Securities Exchange Board of India have given a much required shot in the arm to the mutual fund sector.

The new changes have been geared towards providing greater flexibility to mutual funds and reviving the mutual funds industry.

The mutual fund industry expanded in the 1990s after it was opened to the private sector in 1993. A large number of mutual funds operating in the country has intensified competition and led to product innovation. Mutual funds presently offer a variety of options to investors such as income funds, balanced funds, liquid funds, gilt funds, index funds, exchanged traded funds, sectoral funds, etc. In all, there were 755 schemes (as at end-March 2007) in operation to cater to diverse investor needs.

Net resource mobilisation by mutual funds (net of redemption) increased by 63.6 per cent during 2007-08 to ` 1,53,802 crore – in 2007 & 2008 and further to ` 100,338 crore in 2011-12.

PROFITABILITY FOR AMC

Mutual fund's investment portfolios are continually adjusted under the supervision of a professional manager (known as the portfolio/fund manager), who forecasts the future performance of investments appropriate for the fund and choose those which he or she believes will most closely match the fund's stated investment objective.

The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus, a Mutual Fund offers the opportunity to invest ion a diversified, professionally managed basket of securities with a great deal of flexibility depending on an individual's risk-return goals.

NET ASSET VALUE (NAV)

The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV). Mutual funds invest the money collected from investors in the securities markets. In simple words, NAV is the market value of the securities held by the scheme. Since the market value of the securities change everyday, the NAV also varies on a day-to-day basis.

The NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on any particualr date. For example, if the market value of securities of a mutual fund scheme is ` 200 lakh and the mutual fund has issued 10 lakh units of ` 10 each to the investors, then the NAV per unit of the fund is ` 20. The NAV is requird to be disclosed by the mutual funds on a regular basis — daily or weekly — depending on the type of scheme.

METHOD OF CALCULATION OF UNIT PRICE: NET ASSET VALUE

Units will be allotted on the basis of the Net Asset Value (NAV) of the respective fund as on the date of purchase of units. There in no Bid-Offer spread (the Bid price and offer price of units will both be equal to the NAV). The NAV will be computed on the basis of the investment performance under each fund type and shall be calculated as under:

$$\text{Net Asset Value} = \frac{\begin{array}{l}\text{Market/Fair value of the chosen fund's underlying assets} \\ \text{Plus Current assets, accrued income} \\ \text{(Net of Fund Management charge and other outgo)} \\ \text{less Current Liabilities and Provision}\end{array}}{\text{Number of units existing in the fund at the valuation date}}$$

NAVs change every-day due to fluctuations in the market value of a fund's portfolio. Income received from dividends for equity funds and interest from debt funds, and the expenses of the fund. NAVs rise when the securities that a fund has bought appreciate, and falls when the securities fall. Also, all funds incur expenses from basic operations: investment advisory expenses are paid out of income earned by the fund to arrive at the exact NAV on a particular day. Of course, the NAV on a paritcular day is only on paper, and a fund has to sell the stocks or bonds to realise it.

However, anomalies crop up sometimes in the calculation of NAV, especially when the fund has invested in securities that are not traded. Assessing the realisable value of such unlisted securities is difficult, and hence funds sometimes value these at cost or at book value.

Although this sometimes happens with funds that have invested in thinly traded stocks, it is a real problem with funds that invest primarily in debt. The debt market in India still lacks all-round depth. Debt issued by corporates, in particular, often not traded for weeks or even months on end. Although bond prices don't fluctuate as much as shares, there can easily be a significant difference – as much as couple of percentage points between prices recorded a month or two apart for a debt security.

Such a valuation could skew the calculation of NAV, and make inter-fund comparisons difficult. Worse, if a fund does not recognise its expenses or income. NAV calculation gets distorted.

The net asset value of a mutual funds scheme is basically the per unit market value of all the assets of the scheme. Yet, NAV is only the tool by which one can measure the performance and investment efficiency of the fund over time.

To illustrate this better, a simple example will help.

Scheme Name : XYZ
Scheme Size: ` 50,00,00,000/- (Rupees fifty crores)
Face value of units: ` 10/-
No. of units: 5,00,00,000

$$\frac{\text{Scheme size}}{\text{Face value of units}}$$

Market value of shares: ` 75,00,00,000 (Rupees seventy-five crores)

$$\text{NAV} = \frac{\text{` 75,00,00,000}}{\text{` 5,00,00,000}}$$

$$\frac{\text{Market value of investments}}{\text{No. of units}}$$

Thus, each unit of ` 10/- is now worth ` 15/-.

Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme.

The recommendations of the NAV committee and Mutual Funds 2000 reports which have been approved by the SEBI include giving greater operational freedom to mutual funds in structuring new products such as property funds, money market mutual funds, pension funds among others. Further they can decide on the size of their funds unilaterally. The natural outcome of which is that the minimum subscription clause has become redundant. The industry feels that the removal of minimum corpus size may encourage many funds to target niche segments.

If the mutual funds were to launch such niche funds, they would stand a better chance of pulling it off since the regulations governing the mode of exit have been eased to a great extent. Companies can now float close-ended funds that re-issue and repurchase units at periodic intervals. Or else they can float close-ended funds that can go open ended after a certain period of time. Even the existing funds can make use of these provisions to reduce the discounts at which their schemes quote — provided their unit holders agree.

In a bid to eliminate the problem of discount on listed mutual funds schemes, SEBI has allowed close ended schemes to be listed within six months and has removed the requirement of immediate listing.

SEBI has also allowed issue of repurchased units which would provide liquidity to investors and also provide an incentive to mutual funds to repurchase units from investors in large quantities.

The reforms have also infused a lot of flexibility into the regulations governing investments. An important one is the removal of restriction on investment in the money market instruments. In the past, this restriction had forced many a fund to invest in stocks when the market was booming. With that compulsion no longer valid, mutual funds are free to decide the timing of entry into the stock markets. And they can park as much cash as they desire in money market instruments. The same kind of freedom has been granted to mutual funds in deciding the level of exposure to a particular industry. The exposure limit of 15 per cent of the corpus to particular industry has been removed. Even the aggregate exposure for all schemes put together to a company has been raised from 5 per cent to 10 per cent. This limit will apply only to equity shares and not to debentures as is currently the case. Also, all percentages henceforth will be expressed in terms of net assets instead of corpus.

All in all, the relaxation provides a lot of leeway to fund managers in deploying funds. The reforms also allow borrowing to a limited extent since sudden redemption has the potential to throw the investment strategy of an open ended fund out of gear, now the funds are allowed to borrow up to 10 per cent of their net assets of a scheme for the purpose of redemption.

ROLE OF MUTUAL FUNDS IN THE STOCK MARKET

Mutal funds have played an important role in the development of the capital market. According to SEBI data, net investment by mutual funds in Indian equities during 2007-08 at ` 16,306 crore were much more than the net investments at ` 448 crore in 2004-05. Net investments in debt were ` 73,790 crore in 2007-08 as compared to ` 16,987 crore in 2004-05. The sharp increase of net investment's by mutual funds in equities and debt instruments reflects on their active participation in the stock market.

Mutual funds are an ideal vehicle for investment by retail investors in the stock market for several reasons. First, it pools the investments of small investors together increasing thereby the participation in the stock market. Secondly, mutual funds, being institutional investors, can invest in market analysis generally not available or accessible to individual investors, providing thereby informed decisions to the small investors. Thirdly, mutual funds can diversify the portfolio in a better way as compared with individual investors due to the expertise and availability of funds. Fourthly, growing investor interest in the equity market over the years could also be gauged from the resources mobilised by mutual funds.

Mutual funds in India, because of their small size and slower growth in the 90's, have tended to play only a limited role in the stock market. The share of mutual funds in total turnover of the stock markets (BSE + NSE), which was 4.9 per cent in January 2000, increased to 14.5 per cent by January 2012. One of the reasons for the increase in the share of mutual funds in the turnover was that in the recent past, mutual funds shifted the portfolio composition from equity to debt due to subdued equity market conditions. Mutual funds are very popular all over the world and they play an important role in many countries. As at end June 2008, funds in India constitute less than 12.28 per cent of GDP which is very low in comparison with about 39 per cent in Brazil, 45 per cent in Korea and 82 per cent in the USA.

One of the major reasons for this is that the penetration of mutual funds, especially in the rural areas remains small. According to the survey carried out by SEBI-NCAER (2000), mutual funds have been found to be popular mainly with the middle and high income groups and have not been found to be an attractive investment avenue for the low-income groups. Thus, if mutual funds have to grow fast, they would need to devise appropriate schemes to attract the saving of low-income groups, especially in rural areas. This is the only way to ensure participation of all categories of investors into the capital market, which is so crucial for its long-term development. Mutual funds with large funds at their disposal are also required to act as a counterweight to FIIs, which generally exerts a significant influence on the stock market.

REGULATION AND SUPERVISION OF MUTUAL FUNDS

The focus of regulation and supervision of mutual funds is to facilitate the creation of a structure of mutual funds to cater to the requirements of the nascent economy and the investors. The regulatory framework rests with the Securities and Exchange Board of India (SEBI), the Reserve Bank of India (RBI) and the Association of Mutual Funds of India (AMFI) in introducing an appropriate regulatory environment.

(a) Money market mutual funds that would invest exclusively in money market instruments would be regulated by the Reserve Bank of India on the basis of specified guidelines to be laid down by the RBI. However, money market scheme of other mutual funds would be regulated by the Securities and Exchange Board of India. These regulations will be in conformity with the guidelines to be issued by the Reserve Bank for money market mutual funds investing exclusively in money market instruments.

(b) Offshore funds which have non-residential investors and are regulated by the provisions of the countries where these are registered shall be outside the purview of these guidelines. These funds shall continue to be governed by the rules and procedure laid down for the purpose of approving and monitoring their performance by the department of economic affairs, ministry of finance and the government's/RBI's directives on this subject.

(c) To protect the interest of the investors, SEBI formulates policies and regulates the mutual funds. It notified regulations in 1993 (fully revised in 1996) and issues guidelines from time to time. All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of regulations. All mutual funds are required to be registered with SEBI before they launch any scheme.

The primary purpose of mutual fund regulation in India by the RBI and the SEBI has been to ensure smooth functioning of mutual funds, stability, investors protection and maintain confidence in the mutual funds/AUMs by enhancing their soundness and efficiency.

Over the past few years, there have been several initiatives taken by the regulator to make mutual funds the preferred investment vehicle. It has realised that with the penetration of mutual funds increasing, ensuring simple and timely communication to the investor is essential. Indian mutual fund regulations have established world class standards in accounting, valuation, NAV computation and disclosure norms. All players in the industry feel that a comprehensive risk management framework has also been a step in the right direction in order to safeguard the investors.

The regulatory environment in India is already much better than in many other countries. Disclosure levels are quite high. Typically even portfolios are disclosed on a monthly basis, which is not seen in even some of the developed markets. Also, valuation principles followed in relatively illiquid fixed income securities is consistent across the industry which is again very beneficial to investors. The need of the hour is to raise awareness amongst the large sections of the populace who still don't invest in mutual and bring them on board.

The regulator has done a tremendous job in bringing about such high degrees of financial and operational transparency to the system. When we receive visitors from the global units of AEGON, they have all gone back positively impressed stating that the regulatory and financial infrastructure is world class. Investor education and assistance in penetrating Tier 2 and Tier 3 cities is an area where government and regulatory assistance will be welcome. India as an economy, is moving from 'Defined Contribution' to the 'Defined Benefits' system and investors will need to be educated about building a retirement kitty/medical kitty in the future.

At the same time, the regulator could aim to build a simple yet unbiased education/ counselling platform to ensure that the investor makes a well-informed decision. "These would serve the dual purpose of educating investors in mutual funds leading to enhanced penetration as well as ensuring that the investor can make well-informed decisions, while investing in mutual funds."

However, in order to boost the growth further, the regulator needs to take even more proactive steps so as to increase the efficiency of the market, one forward step in this regard has already been proposed with the regulator expected to allow fast track approvals for new fund offer documents that will enable the AMC's to better time the launch of their products as well as will increase the product line.

Though the no load structure was a good step in the interest of the investor taken by the regulator, a variable load structure should be introduced for the investors who need guidance in terms of their investments, which can be effectively given by distributors. The concept of performance-based fee should be introduced so as to provide more transparency in terms of the fund management activities that will make the fund managers liable for the money that they manage on behalf of the investors.

In a nutshell, more impetus should be given on promoting self-regulation in the industry by encouraging and developing industry best practices, which can be mutually decided between the industry players and regulated through a self regulatory body like AMFI.

THE WAY FORWARD

The future of mutual funds in India is inextricably linked to the growth of the Indian economy, savings and investment patterns, government policy towards private sector and the development of capital market. The government has provided the initial impetus for launching of the funds by providing tax concessions and tax exemptions. The creators of the funds are trusted banks with a good track record. The first step has, therefore, been taken very carefully, ensuring success and building up investor confidence in the new instrument.

Mutual funds in India have a significant and centre-stage role to play in spreading equity cult. The wider range of products/services offered by the funds will make the investor quality-conscious. With the opening up of the unit trust to private sector, there is keen competition for products in the market. And, the private sector has been in forefront in mobilising savings, through mutual funds by offering tailor-made products to the investor. Towards this, the following measures have to be taken.

MEASURES TOWARDS IMPROVEMENT

- Greater clarity to be given to the role of trustees.
- Allow mutual funds to invest through, specialized schemes in real estate, money market instruments, mortgage backed securities, securitised debt and gilt-edged instruments.
- Net worth requirement for an AMC to remain at ` 5 crore.
- Future AMCs to be approved in two stages – an in principle approved followed by a final one, six months later, after the sponsor satisfied all the criteria and demonstrates his commitment to go ahead.
- Unit holders to be given voting rights to be exercised specifically in matters such as change in investment policy and fee structure.
- AMCs to diversify their operations. They should be allowed to undertake related activities such as portfolio management services and offshore funds.
- A new close ended scheme to be allowed to complete listing not later than six months after the closure of the issue.
- Fund managers of close ended schemes may be permitted, with some safeguards, to trade on their own account to bring down market price-NAV gaps (discounts).
- The basis of allotment in case of oversubscription.
- Fund managers to have freedom to choose portfolio composition between capital and money market schemes.
- Mutual funds should be permitted to borrow in certain cases.
- Voting rights for mutual funds in companies in which they have a holding.

CONCLUSION

Mutual funds have become a major vehicle for mobilisation of saving particularly from the small and household sectors for investment in the stock market. In view of their growing importance in the capital market, their expanding investor base and the decision to allow mutual funds to be set up in the joint and private sectors, it has become necessary to evolve a comprehensive set of prudential guidelines for the all-round development and regulation of mutual funds and for ensuring investor protection.

The mutual fund industry the world over has undergone a profound transformation since the 1990s. The changed operating environment for the mutual fund sector, underpinned by globalisation, deregulation, advances in information technology and awareness has resulted in intense competitive pressures. Mutual funds have responded to this challenge by diversifying through organic growth, innovative new products and building trust with the investors.

Although on metrics of penetration such as AUM as a percentage of GDP and AUM as a percentage of bank deposits, the Indian market appears nascent, it is important to recognise that the industry has progressed significantly on several dimensions in a very short span of time. These include product innovation, quicker turn-around time in servicing customers and the emergence of three important third-party channels. Given that distribution in India has already leapfroged to an open system with banks, national distributors and independent financial advisors, all playing an almost equally important role, it is imperative for AMCs to manage distribution partners with care.

Mutual funds in India provide safety, liquidity and growth to investors. They are safe and readily available conduits for channeling savings into investments yielding income and growth. The funds provide stability to share prices, safety to investors and resources to promoter entrepreneurs.

When an economy develops and gains higher levels of affluence, the MFs play a major role in mobilising savings. The generalisation is based on the experience of the US, where the Americans convert almost one billion dollars savings into these funds everyday.

With greater flexibility in operation, the mutual fund industry is expected to play its desired role to harness savings for economic development, inculcate equity culture, strengthening the capital market.

Some of the key pre-requisites for success in the Indian mutual fund space are, innovative marketing, brand building, distribution net work, high quality of fund management, new products, skilled man power, risk management, targeting, research, and a well oiled sales and management machinery. Investor's confidence and regulation and supervision also play a key role in their success.

SELF ASSESSMENT QUESTIONS

(1) Define mutual funds and discuss the modalities.

(2) Discus the different types of mutual funds.

(3) Examine the advantages of mutual funds.

(4) Discuss the role the of mutual funds in the Indian financial system.