CHAPTER – III
MUTUAL FUNDS IN INDIA – AN OVERVIEW

There were a total 39 Mutual Funds as on March 31, 2001. This includes UTI, which is set up under the UTI Act and is not required to be registered with SEBI. There is, however, an arrangement of voluntary compliance by UTI for the schemes launched after July 1994; UTI has made a voluntary compliance with Mutual Fund regulations in respect of many schemes. Five schemes including US-64 do not yet come under the Mutual Fund regulations.

Global scenario in mutual fund

The following lines give some of the basic facts about the Mutual funds in the International arena; the money market mutual fund segment has a total corpus of $1.48 trillion in the US against a corpus of $100 million in India. Out of the top 10 mutual funds worldwide, eight are bank-sponsored. Only Fidelity and Capital are non-bank mutual funds in this group. In the US the total number of schemes is higher than that of the listed companies, while in India we have just 277 schemes. Internationally, mutual funds are allowed to go short. In India fund managers do not have such leeway. In the U.S. about 9.7 million households will manage their assets on-line by the year 2003, such a facility is not yet of avail in India. On-line trading is a great idea to reduce management expenses from the current 2% of total assets to about 0.75% of the total assets. 7.72% of the core customer base of mutual funds in the top 50-broking firms in the US is expected to trade on-line by 2003. The recent trend in the arena of mutual fund is investment through Internet Internationally; on-line investing continues its meteoric rise. Many have debated about the success of e-commerce and its breakthroughs, but it is true that this aspect of technology can and will change the way financial sectors function. However, mutual funds cannot be left far behind. They have realized the potential of the Internet and are equipping themselves to perform better. In fact in advanced countries like the USA mutual funds
buy-sell transactions have already begun on the net, while in India the Nets used as a source of Information.

**Mutual fund in India**

Nowadays, bank rates have fallen down and are generally below the inflation rate. Therefore, keeping large amounts of money in bank is not a wise option, as in real terms the value of money decreases over a period of time. One of the alternate options is to invest the money in stock market. But a common investor is not informed and competent enough to understand the intricacies of stock market. This is where mutual funds come to the rescue. A mutual fund is a group of investors operating through a fund manager to purchase a diverse portfolio of stocks or bonds. Mutual funds are highly cost efficient and very easy to invest in. The biggest advantage of mutual funds is diversification of risk diversification that means spreading out money across many different types of investments. When one investment is down, another might be up. Diversification of investment holdings reduces the risk tremendously. Mutual funds as dynamic financial institutions play a crucial role in an economy by mobilizing savings, and investing them in the capital markets. Thus mutual funds establish a link between savings and the capital market. They mobilize funds in the savings market and act as complementary to banking. At the same time, they also compete with the banks and other financial institutions. In the process, stock market activities are also significantly influenced by mutual funds. However, the scope and efficiency of mutual funds are influenced by overall economic fundamentals, the interrelationship between the financial sectors and the investors, the nature of the savings, the Development of capital markets, market structure and institutional arrangements.

The mutual funds play an active role in promoting a healthy capital market. The mutual funds increase liquidity in the money market. The asset holding pattern of mutual funds all over the world indicates the dominant role of mutual funds in money and capital market. Mutual funds have been identified as one of the important factors pushing up the market prices of securities. Mutual funds in India have emerged as a critical institutional linkage among various financial segments like savings, capital markets and the corporate sectors. Above all, mutual funds have given a new direction
to the flow of personal savings and enabled small and medium investors in remote rural and semi-urban areas to reap the benefits. Thus, mutual funds are playing a crucial role in allocating resources in emerging market economy.

**History of the Indian Mutual Fund Investment**

The formation of Unit Trust of India marked the evolution of the Indian mutual fund industry in the year 1963. The primary objective at that time was to attract the small investors and it was made possible through the collective efforts of the Government of India and the Reserve Bank of India. The history of mutual fund industry in India can be better understood as it is divided into following phases:

**Phase I. Establishment and Growth of Unit Trust of India: 1964-87**

Unit Trust of India enjoyed complete monopoly when it was established in the year 1963 by an act of Parliament. UTI was set up by the Reserve Bank of India and it continued to operate under the regulatory control of the RBI. 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 1970s and 80s to suit the needs of different investors. It launched ULIP in 1971. By the end of 1987, UTI’s assets under management grew ten times to Rs 6700 cores.

**Phase II. Entry of Public Sector Funds: 1987-1993**

The Indian mutual fund industry witnessed a number of public sector players entering the market in the year 1987. In November 1987, SBI Mutual Fund from the State Bank of India became the first non-UTI mutual fund in India. SBI Mutual Fund was later followed by canara bank Mutual Fund, LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. By 1993, the assets under management of the industry increased seven times to Rs. 47,004 cores. However, UTI remained to be the leader with about 80% market share.

**Phase III. Emergence of Private Sector Funds: 1993-96**

The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian
promoters) to enter the mutual fund industry in 1993, provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor-servicing technology. By 1994-95, about 11 private sector funds launched their schemes.

**Phase IV. Growth and SEBI Regulation: 1996-2004**

The mutual fund industry witnessed robust growth and stricter regulation from the SEBI after the year 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 safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them.

SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. 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 AMFI, with an objective to educate investors and make them informed about the mutual fund industry.

**Phase V. Growth and Consolidation: 2004 Onwards**

The industry has also witnessed several mergers and acquisitions recently, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players.

**Organizational Structure of Mutual Fund**

A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and a Custodian. The trust is established by a sponsor or more than one sponsor who is like a 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 investments in various types of securities. The custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI regulations by the mutual fund.

Sponsor

The sponsor is required, under the provisions of the Mutual Fund Regulations, to have a sound track record, a reputation of fairness and integrity in all his business transactions. Additionally, the sponsor should contribute at least 40% to the net worth of the AMC. However, if any person holds 40% or more of the net worth of an AMC shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in the Mutual Fund Regulations. The sponsor or any of its directors or the principal officer employed by the mutual fund should not be guilty of fraud, not be convicted of an offence involving moral turpitude or should have not been found guilty of any economic offence.

Trustees

The trustees are also required to ensure that an AMC has been diligent in empanelling and monitoring any securities transactions with brokers so as to avoid any undue concentration of business with any broker. The Mutual Fund Regulations, further, mandates that the trustees should prevent any conflicts of interest between the AMC and the unit holders in terms of deployment of net worth.

Asset Management Company

The sponsor or the trustees are required to appoint an AMC to manage the assets of the mutual fund. Under the Mutual Fund Regulations, the applicant must satisfy certain eligibility criteria in order to qualify to register with SEBI as an AMC. The sponsor must have at least 40% stake in the AMC.

The directors of the AMC should be persons having adequate professional experience in finance and financial services related field and not found guilty of moral turpitude or convicted of any economic offence or violation of any security laws. The AMC should have at all times maintain, a minimum net worth of Rs. 10 Crores. The
board of directors of such AMC has at least 50% directors, who are not associates of or associated in any manner with, the sponsor or any of its subsidiaries or the trustees. The Chairman of the AMC is not a trustee of any mutual fund.

The AMC cannot undertake any other business activities except activities in the nature of portfolio management services, management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual fund.

**Custodian**

The mutual fund is required under the Mutual Fund Regulations, to appoint a custodian to carry out the custodial services for the schemes of the fund. Only institutions with substantial organizational strength, service capability in terms of computerization, and other infrastructure facilities are approved to act as custodians. The custodian must be totally de-linked from the AMC and must be registered with SEBI. Under the Securities and Exchange Board of India (Custodian of Securities) Guidelines, 1996, any person proposing to carry on the business as a custodian of securities must register with the SEBI and is required to fulfill specified eligibility criteria. Additionally, a custodian in which the sponsor or its associates holds 50% or more of the voting rights of the share capital of the custodian or where 50% or more of the directors of the custodian represent the interest of the sponsor or its associates cannot act as custodian for a mutual fund constituted by the same sponsor or any of its associate or subsidiary company.

**Association of Mutual Funds in India (AMFI)**

Association of Mutual Funds in India (AMFI) is an apex body of asset management companies of the Mutual Fund registered in India. It was incorporated on 22nd August 1995 as a non-profit making organization. It is dedicated to developing the Indian Mutual Fund industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of Mutual Funds and their unit holders.
Role of mutual funds

Mutual Funds and Financial Market

In the process of development Indian mutual funds have emerged as strong financial intermediaries and are playing a very important role in bringing stability to the financial system and efficiency to resource allocation. Mutual Funds have opened new vistas to investors and imparted a much-needed liquidity to the system. In the process they have challenged the hitherto role of commercial banks in the financial market and national economy.

Mutual Fund and Capital Market

The active involvement of Mutual Funds in promoting economic development can be seen not only in terms of their participation in the saving market but also in their dominant presence in the money and capital market.

A developed financial market is critical to overall economic development, and Mutual Funds play an active role in promoting a healthy capital market. The asset holding pattern of mutual funds in the USA indicates the dominant role of Mutual Funds in the capital market and money market. Moreover they have also rendered critical support to securities mortgage loans and municipal bond market in the USA.

In the USA, Mutual Funds provide very active support to the secondary market in terms of purchase of securities. Investors preference pattern in India has undergone a tremendous change during recent times, along with the changes in the share of financial assets in the total annual savings. Indian investors have moved towards more liquid & growth oriented trade able instruments likes shares/debentures and units of Mutual Funds. The shift is asset holding Pattern of investors has been significantly influenced by the ‘equity’ and ‘unit’ culture while the holders of company shares and debentures are concentrated in the urban areas, small/medium investors in the semi-urban and rural areas are tending towards Mutual Funds. Mutual Funds in India have certainly created awareness among investors about equity-oriented investments and its benefits.
Role of fund managers

The mutual fund is managed by a professional investment manager who buys and sells securities for the most effective growth of the fund. As a mutual fund investor, you become a "shareholder" of the mutual fund company. When there are profits, you will earn dividends. When there are losses, your shares will decrease in value. The investment experts who invest the pooled money on behalf of investors of the scheme are known as Fund Managers. These fund managers take the investment decisions pertaining to the selection of securities and the proportion of investments to be made into them. However, these decisions are governed by certain guidelines which are decided by the investment objectives, investment pattern of the scheme and are subject to regulatory restrictions. It is this investment objective and investment pattern which also guides the investor in choosing the right fund for his investment purpose.

Importance of mutual fund

Small investors face a lot of problems in the share market, limited resources, lack of professional advice, lack of information etc. Mutual funds have come as a much needed help to these investors. It is a special type of institutional device or an investment vehicle through which the investors pool their savings which are to be invested under the guidance of a team of experts in wide variety of portfolios of corporate securities in such a way so as to minimize risk, while ensuring safety and steady return on investment. It forms an important part of the capital market, providing the benefits of a diversified portfolio and expert fund management to a large number particularly small investors.

Nowadays, mutual fund is gaining its popularity due to the following reasons:

1. As mutual funds are managed by professionals, they are considered to have a better knowledge of market behaviors. Besides, they bring a certain competence to their job. They also maximize gains by proper selection and timing of investment.
2. Another important thing is that the dividends and capital gains are reinvested automatically in mutual funds and, hence, are not frittered away. The automatic reinvestment feature of a mutual fund is a form of forced saving and can make a big difference in the long run.

3. The mutual fund operation provides a reasonable protection to investors. Besides, presently all schemes of mutual funds provide tax relief under Section 80 L of the Income Tax Act and in addition, some schemes provide tax relief under Section 88 of the Income Tax Act lead to the growth of importance of mutual fund in the minds of the investors.

4. As mutual funds create awareness among urban and rural middle class people about the benefits of investment in capital market, through profitable and safe avenues, mutual fund could be able to make up a large amount of the surplus funds available with these people.

**Risks involved in mutual funds**

Mutual funds also involve risk which the investors have to confront while investing in the industry.

1. The companies in which the fund has invested might perform poorly, suffer mismanagement.

2. Some economic, political or other development might cause the overall market to fall, dragging down with it the holdings of one’s particular fund.

**Managing risks**

Mutual funds offer incredible flexibility in managing investment risk. Diversification and Automatic Investing (SIP) are two key techniques you can use to reduce your investment risk considerably and reach your long-term financial goals.

**Diversification**

When you invest in one mutual fund, you instantly spread your risk over a number of different companies. You can also diversify over several different kinds of securities by investing in different mutual funds, further reducing your potential risk. Diversification is a basic risk management tool that you will want to use throughout
your lifetime as you rebalance your portfolio to meet your changing needs and goals. Investors, who are willing to maintain a mix of equity shares, bonds and money market securities, have a greater chance of earning significantly higher returns over time than those who invest in only the most conservative investments. Additionally, a diversified approach to investing combining the growth potential of equities with the higher income of bonds and the stability of money markets helps moderate your risk and enhance your potential return.

**Systematic Investment Plan (SIP)**

The unit holders of the scheme can benefit by investing specific rupee amounts periodically, for a continuous period. Mutual fund SIP allows the investors to invest a fixed amount of rupees every month or quarter for purchasing additional units of the scheme at NAV based prices.

**Types of risks**

These common types of risk and evaluate them against potential rewards when you select an investment.

**Market Risk**

At times the prices of all the securities in a particular market rise or fall due to broad outside influences. When this happens, the stock prices of both an outstanding, highly profitable company and a fledgling corporation may be affected. This change in price is due to "market risk".

**Inflation Risk**

Inflation risk also occurs when prices rise faster than your returns.

**Credit Risk**

In short, how stable is the company or entity to which you lend your money when you invest.

**Exchange Risk**

A number of companies generate revenues in foreign currencies and may have investments or expenses also denominated in foreign currencies. Changes in exchange
rates may, therefore, have a positive or negative impact on companies which, in turn, would have an effect on the investment of the fund.

**Investment Risk**

The sectoral fund schemes, investments will be predominantly in equities of select companies in the particular sectors. Accordingly, the NAV of the schemes are linked to the equity performance of such companies and may be more volatile than a more diversified portfolio of equities.

**Change in the Government Policy**

Changes in Government policy, especially in regard to the tax benefits, may impact the business prospects of the companies leading to an impact on the investments made by the fund.

**Different types of mutual fund schemes**

Mutual Fund schemes can be classified into different categories and subcategories based on their maturity periods and their investment objectives.

**Based on the maturity period**

**Open-ended Fund**

An open-ended fund is a fund that is available for subscription and can be redeemed on a continuous basis. It is available for subscription throughout the year and investors can buy and sell units at NAV related prices. These funds do not have a fixed maturity date. The key feature of an open-ended fund is liquidity.

**Close end fund**

A close-ended fund is a fund that has a defined maturity period, e.g. 3-6 years. These funds are open for subscription for a specified period at the time of initial launch. These funds are listed on a recognized stock exchange.

**Interval Funds**

Interval funds combine the features of open-ended and close-ended funds. These funds may trade on stock exchanges and are open for sale or redemption at predetermined intervals on the prevailing NAV.
Based on investment objectives

Equity or Growth funds

Equity or Growth funds invest a major part of its corpus in stocks and the investment objective of these funds is long-term capital growth. Equity funds invest minimum 65% of its corpus in equity and equity related securities. These funds may invest in a wide range of industries or focus on one or more industry sectors. These types of funds are suitable for investors with a long-term outlook and higher risk appetite.

Debt or Income Funds

Debt or Income funds generally invest in securities such as bonds, corporate debentures, government securities (gilts) and money market instruments. These funds invest minimum 65% of its corpus in fixed income securities. By investing in debt instruments, these funds provide low risk and stable income to investors with preservation of capital. These funds tend to be less volatile than equity funds and produce regular income. These funds are suitable for investors whose main objective is safety of capital with moderate growth.

Balanced Funds

Balanced funds invest in both equities and fixed income instruments in line with the pre-determined investment objective of the scheme. These funds provide both stability of returns and capital appreciation to investors. These funds with equal allocation to equities and fixed income securities are ideal for investors looking for a combination of income and moderate growth. They generally have an investment pattern of investing around 60% in Equity and 40% in Debt instruments.

Money Market or Liquid Funds

Money market or Liquid funds invest in safer short-term instruments such as Treasury Bills, Certificates of Deposit and Commercial Paper for a period of less than 91 days. The aim of Money Market and Liquid Funds is to provide easy liquidity, preservation of capital and moderate income. These funds are ideal for corporate and individual investors looking for moderate returns on their surplus funds.
Gilt Funds

Gilt funds invest exclusively in government securities. Although these funds carry no credit risk, they are associated with interest rate risk. These funds are safer as they invest in government securities.

Some of the common types of mutual funds and what they typically invest in:

<table>
<thead>
<tr>
<th>Type of Fund</th>
<th>Typical Investment</th>
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<tbody>
<tr>
<td>Equity or Growth fund</td>
<td>Equities like stocks</td>
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<tr>
<td>Fixed income Fund</td>
<td>Fixed income securities like government and corporate bonds</td>
</tr>
<tr>
<td>Money market fund</td>
<td>Short-term fixed income securities like treasury bills</td>
</tr>
<tr>
<td>Balanced fund</td>
<td>A mix of equities and fixed income securities</td>
</tr>
<tr>
<td>Sector-specific Fund</td>
<td>Sectors like IT, Pharma, Auto etc.</td>
</tr>
<tr>
<td>Index fund</td>
<td>Equities or Fixed income securities chosen to replicate a specific Index for example S&amp;P CNX Nifty</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>Other mutual funds</td>
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Other Schemes

Tax-Saving (Equity linked Savings Schemes) Funds

Tax-saving schemes offer tax rebates to investors under specific provisions of the Income Tax Act, 1961. These are growth-oriented schemes and invest primarily in equities. Like an equity scheme, they largely suit investors having a higher risk appetite and aim to generate capital appreciation over medium to long-term.

Index Funds

Index schemes replicate the performance of a particular index such as the BSE Sensex or the S&P CNX Nifty. The portfolio of these schemes consist of only those stocks that represent the index and the weight age assigned to each stock is aligned to
the stocks weight age in the index. Hence, the returns from these funds are more or less similar to those generated by the Index.

**Sector-specific Funds**

Sector-specific funds invest in the securities of only those sectors or industries as specified in the Scheme Information Document. The returns in these funds are dependent on the performance of the respective sector or industries for example FMCG, Pharma, IT, etc. The funds enable investors to diversify holdings among many companies within an industry.

**New Product categories**

**Capital Protection Oriented schemes**

The term ‘capital protection oriented scheme’ means a mutual fund scheme which is designated as such and which Endeavors to protect the capital invested therein through suitable orientation of its portfolio structure. SEBI stipulations require these types of schemes to be close-ended in nature, listed on the stock exchange and the intended portfolio structure would have to be mandatory rated by a credit rating agency.

**Gold Funds**

The objective of these funds is to track the performance of Gold. The units represent the value of gold or gold related instruments held in the scheme. Gold Funds which are generally in the form of an Exchange Traded Fund (ETF) are listed on the stock exchange and offers investors an opportunity to participate in the bullion market without having to take physical delivery of gold.

**Real Estate Mutual Funds**

SEBI recently paved way for the launch of such products, by making amendments to its existing regulations. However, real estate mutual funds are yet to be introduced in India by any asset management company. These schemes invest in
real estate properties and earn income in the form of rentals, capital appreciation from developed properties. REMFs are required to be close-ended in nature and listed on a stock exchange.

**Investment options available to investors**

**Growth option**

Under growth option, dividends are not paid out to the unit holders. Income attributable to the unit holders continues to remain invested in the scheme and is reflected in the NAV of units under this option. Investors can realize capital appreciation by way of an increase in NAV of their units by redeeming them.

**Dividend Payout option**

Dividends are paid out to the unit holders under this option. However, the NAV of the units falls to the extent of the dividend paid out and applicable statutory levies.

**Dividend Re-investment option**

The dividend that accrues on units under option is re-invested back into the scheme at ex-dividend NAV. Hence, investors receive additional units on their investments in lieu of dividends.