CHAPTER 1

INTRODUCTION

1.1 RATIONALE OF THE STUDY

Investment has been a crucial decision for individual investors since ancient times. Purchase of some asset from the surplus of income over expenditure to generate more money is investment. In other words, investment can be defined as the commitment of funds to one or more assets that will be held over some future time period [95]. In Graham’s words “Investment is putting money into something upon thorough analysis, with the expectation of gain that has a high degree of security for the principal amount, as well as security of return, within an expected period of time ” [68]. Therefore, it entails arriving at numerous decisions such as investment amount, type of securities and timing. All investment choices are made in accordance with personal investment needs and in consternation of an uncertain future. Further such decision making has to be persistent and rational.

In early days of around 9,000 to 500 B.C. people used to invest their savings in livestock as cows and sheep, agricultural products as grain and vegetables and precious metal as silver and gold and land. That is, these were the traditional means of investment. In those days, investment was mainly for the purpose of preserving the money. Revolution in investment took place in 20th century with the introduction of banking system with many investment options as fixed deposits, post office savings, national saving certificate and bonds. These options would serve the dual purpose i.e., provide returns as well as preserve the principal. The modern concept of investment states that any form of investment carries some degree of risk with it. Today many modern means of investment are available to the investors. Some of them carry low risk and low returns such as bank fixed deposits, national saving certificates, government securities, public provident fund etc. Some are high risk high return investment options such as commodity market, real estate, stock markets and mutual funds. These investment options provide different risk-return trade off catering to different types of needs of investors.
Among low risk investment options, bank fixed deposit with almost zero default risk and no uncertainty in future cash flows is a popular avenue for the conservative investors. With a tenure ranging from 7 days to 10 years, this option provides an advantage of liquidity to the investors as the money can be withdrawn prematurely subjected to some penalty as prescribed by the bank on the date of deposit. National Savings Certificates (NSC), issued by department of Post, Government of India is specially designed for government employees, businessmen and other salaried classes who are income tax assesses. In India, NSC has been ranked as ‘highly secured’ and it provides to the investors, tax advantage on their Investment\(^1\).

The other investment options are corporate bond and government securities. According to Securities and Exchange Board of India (SEBI), corporate bonds are debt instruments issued by a corporation, the holder of which receives interest from the corporation periodically for a fixed period of time and gets back the principal with interest due at the end of the maturity period. According to Reserve Bank of India, a government security is a tradable instrument issued by the Central Government or the State Governments that acknowledges the Government’s debt obligation. Such securities are short term as treasury bills, with original maturities of less than one year or long term as Government bonds or dated securities with original maturity of one year or more. Treasury bills are issued by the Central Government while bonds or dated securities are issued by both the Central as well as State Government. Government securities carry practically no risk of default and, hence, are called risk-free gilt-edged instruments. Public Provident Fund (PPF) acts as investment cum tax saving instrument for investors and also serves as a retirement-planning tool. This scheme was introduced by Central Government in 1968 and it enables the retail investors to make contributions to the fund and obtain Income Tax rebate under the relevant provisions of the Income Tax\(^2\).

Among the high risk investment options, Commodity market got its roots in 17th century when rice futures were traded in Japan. Nowadays it facilitates investors to trade in precious metals, other metals, agro-based commodities, soft commodities, live-stock and energy. Investment in e-gold provides an opportunity for small investors to invest in gold in smaller denominations of one gram and multiple thereof. Development of modern investment system took a fast pace with the introduction of securities market. The organisation of

\(^1\) Source: http://www.nscindia.org.in/; downloaded on 09/07/12
\(^2\) Source: http://www.sbi.co.in/user.htm; downloaded on 09/07/12
security exchanges marks the final step in the modern investment development. People invest in security markets for the appreciation of their savings and for this, they generally take risk as with any investment in securities, the value of the portfolio can go up and down depending on the factors and forces affecting the securities market. These factors and forces are the performance of individual companies, changes in the general market conditions, level of interest rates, currency exchange rates, changes in government policy, taxation laws, regulatory requirements, prevailing political and economic environment and so on. Therefore, investors must have handful of knowledge about the performance of securities and should reappraise and re-evaluate their various investment commitments in the light of new information, changed expectations and ends [17]. Investment in stocks produces high returns only when investment and disinvestment is made at right time that in turn requires investor’s time and expertise to understand the movements of the stock market. For investors, who do not possess such expertise and time, mutual funds have emerged as an ultra modern method of investment which lessens the risk and increases diversification at low cost.

Mutual fund is an investment vehicle that pools the money of investors and invests it in a variety of securities as shares, bonds, debentures etc., according to fund’s specific objectives and strategies. The money thus generated is distributed among investors in the proportion of number of units held by them. Mutual fund acts as a means of participation in the stock market for people who do not have the time and expertise to take direct investment decisions in the equities successfully. Mutual funds serve as a link between the savings of public and capital market as they mobilise savings from investors to the borrowers in the capital markets. By the very nature of their activities, and by virtue of being knowledgeable and informed investors, mutual funds influence the stock markets. Also they play an active role in promoting good corporate governance, investor protection and the health of capital markets. Mutual funds have imparted the much needed liquidity into the financial system and have challenged the hitherto dominant role of banking and financial institutions in the capital markets.

In India, mutual funds have gained immense popularity in terms of number and type of schemes and asset under management during last decade. Several new and innovative instruments in mutual fund industry have been introduced by the SEBI with a view to attract more and more customers. This has also resulted in an increased competition in the mutual fund market that forces mutual fund companies to constantly evaluate their performance in
terms of returns from the mutual fund schemes. Mutual fund companies have to keep a check on the performance of their funds, so that the cause for underperforming schemes can be detected and they can offer better performing schemes to the investors. Also regulatory bodies as Security and Exchange Board of India (SEBI) and Association of Mutual Funds in India (AMFI) constantly appraise fund policies to get an idea as what kind of mutual funds show superior performance and survive in the market.

The role of regulatory bodies is to make sure that the fund has been sticking to its objectives and is following regulatory norms i.e., they investigate if funds are sticking to the regulations. Overall security-wise weightings, derivative exposures, proper recording of transactions and correct dissemination of information have to be checked. They also check whether losses on stocks and derivatives are being passed on to underperforming schemes. Concerned over non-performance of some schemes over a long period of time, SEBI Chairman, U K Sinha, declared to conduct inspection on Asset Management Companies for not following rules with regard to the fund objectives. He said, the capital market regulator is considering questioning CEOs and fund managers of mutual fund schemes, which are not performing well over a long-term basis since inception and the Management of mutual funds should look into the areas of no-performance.

Therefore, regulatory bodies keep a check on the performance of mutual fund schemes and frame the policies accordingly from time to time. With the growth of mutual fund companies their investor base has also increased. As the number of mutual fund companies and schemes has been increasing day by day, retail investors are facing problems in selecting right funds from the plethora of schemes existing in the Indian mutual fund industry. Therefore, it is a very important issue to study the performance of mutual funds. That is in Indian mutual fund industry, with the given input and output, how many mutual fund schemes are performing efficiently and how many are performing inefficiently.

For measuring the performance of mutual funds, in general, Net Asset Value (NAV) is taken as a criteria and the performance measurement is based on the risk and return trade off only. Apart from risk, there are several other inputs that mutual fund companies take from the investors for giving output as performance. Mutual fund schemes possess several characteristics or attributes such as their past performance, expenses, load fee, asset size,

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3 Business Standard, July, 18 2012
investment style, risk involved, age of the scheme since inception etc. that might affect their performance. It is very essential to know which attribute results in efficient performance and which attribute deteriorates the performance efficiency of mutual funds. This will help mutual fund companies in giving better performance from their schemes. This might also help policy makers in framing suitable policies. For example, SEBI’s advisory panel, for enhancing the growth of Indian mutual fund industry accepted the demand of mutual fund companies and favoured raising the total expense ratio by 20-25 basis points. The committee also suggested levying service tax in addition to the total expense ratio. (Business Line, July 17, 2012). Therefore, it is of crucial importance to explore relationship of these attributes with the performance in terms of efficiency of mutual funds. Understanding this relationship will also help investors to select efficiently performing mutual fund catering to their need.

In India, mutual funds have large investors base but with respect to other developed nations, it is still lacking far behind. In developed financial markets like the United States (U.S.), mutual funds have almost overtaken bank deposits and total assets of insurance funds [99]. As at the end of the year 2010, in the U.S. alone there were 7581 mutual funds with assets under management of over U.S. $11.8 trillion. This is the largest in the world, accounting for 48 percent of $24.7 trillion in mutual fund assets worldwide.

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**Figure 1.1:** Worldwide mutual fund markets (Percent of total assets, 2010)

The European mutual fund market with $7.9 trillion in assets under management accounted for 32 percent of the mutual fund assets worldwide at the end of the year 2010 and is on the second place. Africa and Asia/Pacific manages only 13 percent with $3.2 trillion assets under management whereas other Americas manage 7 percent of the mutual fund assets worldwide. In all this, India manages only 0.5 percent of mutual fund assets worldwide (Figure 1.1). Indian mutual fund industry possesses a lot of potential to grow. One of the main reasons for poor growth of mutual fund industry in India is the lack of awareness for mutual funds and lack of trust on mutual fund companies and policy makers in investors [151], [119], [148], [52], [122], [120]. Therefore, for promoting the growth of mutual funds and to make it a successful industry in India, it is very crucial to understand the perception of retail investors towards mutual funds.

Before investing in any investment avenue, investors judge it on several parameters such as return, risk, liquidity, tax savings, procedural understanding, and diversification and so on. An investigation, as where investors put different investment options on these parameters will help mutual fund companies and policy makers in the better performance of mutual funds. It will further help them to frame suitable policies. Also by knowing investors needs and preferences, companies can provide them more suitable mutual fund schemes.

Now, there might be several investors who do not invest in mutual funds presently but by taking some actions on the part of mutual fund companies and policy makers, they may be motivated towards this investment. For tracking these potential customers, companies must know various factors in which mutual funds are lacking in comparison to other investment options. Also awareness of the mutual funds characteristics that investors consider before investing in their schemes is of enormous importance for mutual fund companies. Mutual Fund industry is gaining popularity and provides the ideal platform for retail investors in India, but to avail this opportunity, retail investors should be aware about mutual funds and its related information like the name of Asset Management Company, various schemes, benefits, and characteristics affecting performance and so on. Hence researcher agencies, mutual fund companies and policy makers must know the attitudes, perception, behaviour and level of awareness for retail investors with reference to Mutual Funds.

From the above discussion, it is clear that Indian mutual fund industry is in its growth phase and possesses a tremendous scope for development. There are some crucial issues
which need to be investigated. First and foremost, the performance of mutual funds in terms of their efficiency with their set of input and output should be checked. Also, the impact of attributes on the performance of mutual funds should be explored. Further, the perception of investors towards mutual funds and other investment options should be studied. This will answer the question, ‘where the mutual funds stand with respect to other investment options and due to which factors they adopt this position’.

One more research issue to explore is various steps or measures to be taken by the mutual fund companies and policy makers so that investors might be motivated towards mutual fund investment. In this way, the present study will be of vital importance as it might help to understand why an investor invests in a particular security and his likely reaction to the uncertainty in investing while still satisfying the individual preferences. Investors with positive perception and attitude will continue to invest in a particular investment option while the one with negative perception will discontinue the investment. Therefore, through this study, mutual fund companies and policy makers would be benefited by knowing the needs, attitude, perception, knowledge and awareness of investors about mutual funds individually and with respect to other investment options. Also it would help mutual fund companies, investors, researchers and policy makers to get an idea of the performance of mutual funds in India

1.2 ORGANISATION OF THE STUDY

The study is organised as follows. In chapter 2, an overview of the Indian mutual fund industry has been provided. This chapter has been devoted to the discussion of the conceptual framework for mutual funds, their attributes, types, history (i.e., origin and growth), legal and regulatory environment, valuation and cost of investment etc. Chapter 3 discusses the past literature both in terms of concept and empirical study. In depth literature review regarding performance of mutual funds and perception of investor’s has been provided in the same chapter. Objectives of the study have also been provided in chapter 3 only.

In chapter 4, Methodology has been discussed. This gives the detail of database, population, sample, sampling frame, data collection, tools, techniques and methodologies used for the study. Description of the statistical techniques used has also been provided in this
chapter. Analysis of secondary data for studying the performance of mutual funds as well as primary data for studying the investors’ behaviour along with their interpretation has been presented in chapter 5. Chapter 6 provides the research outcome i.e., findings of the study. In chapter 7, suggestions, limitations of the study, some scope for further research and the conclusion of the study has been presented.