The Fourth Chapter discusses the Socio – Economic Profiles of the respondents.

The Fifth Chapter looks into the Attitude of Investors and Brokers Towards Mutual Funds

The Sixth Chapter is concerned about the Factors Influencing Investment in Mutual Funds in the study area.

The last and Final Chapter contains the Summary of Findings, Conclusions and Suggestions.

2.1 Introduction

The Indian financial system is based on four basic components viz., financial market, financial institutions, financial service, and financial instruments. All the four play an important role for the transfer and allocation of the funds. The main aim of the Indian financial system is to provide efficient services to the capital market. The Indian capital market has been expanding tremendously during the second generation reforms.

The 1997 second generation reforms includes reforms on industrial investment, fiscal policy, ex-imp policy, public sector, financial sector, foreign investment through the institutional investors and banking sectors. The economic development model adopted by India in the post-independence era is called mixed economy with the public sector playing a dominating role and the activities of the private industrial sector were regulated from time to time. The last two decades (1991-2000, 2001-2010) had been a phenomenal expansion in the geographical coverage and the financial spread of our financial system.
The spread of the banking system had been a major factor in promoting financial intermediation in the economy and in the growth of financial savings with progressive liberalization of economic policies: There had been a rapid growth of capital market, money market and financial services industry including merchant banking, leasing, venture capital and hire purchasing. There arose a need to provide an efficient service to the investor. If the investors come forward with small amounts for investment, the mutual fund must help them with better services. The main vision for this study is to scrutinize the performance of the star rated mutual funds (highly successful funds), given the weight of risk, return, and assets under management, net assets value, book value and price earnings ratio.\textsuperscript{53}

A mutual fund is a single and large professionally managed organization that combines the funds of many individual investors having similar investment objectives. It designs its schemes to meet the needs of different types of investors in terms of nature of investments. Mutual fund activity has come to play an important role in our development efforts.

### 2.2 Definitions

SEBI (Mutual Funds) Regulation 1993, defines mutual fund as, “a fund established in the form of a trust by a sponsor to raise money 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.”

Frank Reilly defines “a mutual fund as financial intermediaries who bring a wide variety of securities within the reach of the most modest of investors.”\textsuperscript{54}
VNR Dictionary of Business and Finance defines mutual fund as “an investment fund that pools the invested funds of others and invests those funds on their behalf, usually in a specific kind of investment, such as money market instruments municipal bonds or common stock.”^55

As per the Mutual Fund Fact Book published by the Investment Company Institute of the USA “A mutual fund is a finance services organization that receives money from shareholders, invest it, earn returns on it, attempts to make it grow and agree to pay the shareholders cash on demand for the current value of his investment.”^56

William F. Sharpe defines open-ended mutual fund as, “an investment company that stands ready at all times to purchase its own shares at or near their net asset value is termed as open-ended investment company. Most of these companies commonly known as ‘mutual funds’, also continuously offer new shares to the public for a price at or near their net asset values. He defines close-ended mutual fund as follows: “Close-end investment companies do not stand ready to purchase their own shares whenever one of their owners decides to sell them. Instead their shares are treated either as an organized exchange or in the Over the Counter market.”^57

Encyclopaedia Britannica defines a mutual fund as, “Mutual Fund is also called Unit Trust or Open-end Trust, company that invests the fund of its subscribers in diversified securities and in return issues units representing shares in those holdings. It differs from the investment trust, which issues shares on its own capital. With regards to investment capital to closed-end investment companies, which have a fixed

^56 Mutual Fund Fact Book 1940.
^57 William F. Sharpe and Gordan j. Alexander, Investments, 1994, pp. 637-640,
capitalization and whose shares are bought and sold by the investors in the market, mutual funds make a continuous offering of new shares at net asset value (plus a sales charge) and redeem their shares on demand at net asset value, determined daily by the market value of the securities they hold” 58

From the above definitions it can be seen that a mutual fund or unit trust is a financial intermediary established in the form of trust, sponsored by banks, insurance, financial and other industrial companies to mobilize savings from the public at large (mostly household), by launching various schemes which are different in objectives and operation and investing the pooled savings in various instruments of capital and money markets. The funds so mobilized are managed by professionals and are invested in various securities of divergent companies of different industries, which facilitate the diversification and minimize the risk. In short, mutual fund is a trust, which pools the savings of number of investors who share common financial goal. Professional Investment managers invest this fund in securities and pass back income earned to the investors in the form of dividend or increase in the value of fund.

2.3 Concept of Mutual Funds

After second generation reforms the growth of the economy, the capital market in India and the size of investors had also increased rapidly. In fact, small investors in India have begun to regularly invest in public issues and in financially big and small green field projects of known and unknown promoters. They have been benefited from such investments in the past. As the stock market crumbled later on, in 2009 when prices of new issues plummeted, small investors again began looking for a good opportunity

for investments. In this situation, mutual funds rose up to provide the opportunity to the public. Figure 2.1 below presents the pooling of the mutual funds.

Figure 2.1

Mutual Funds as Financial Intermediaries

Investment

Earnings and Appreciation

Professional fund Management Fee

Mutual funds

Pooling savings

Small investors

Returns

Source: Mutual funds management and working book 1996.

When an investor subscribes for the units of a mutual fund, he becomes part owner of the assets of the fund in the same proportion as his contribution amount put
up with the corpus (the total amount of the fund). Mutual Fund investor is also known as a mutual fund shareholder or a unit holder.

Any change in the value of the investments made into capital market instruments (such as shares, debentures and the like) is reflected in the Net Asset Value (NAV) of the scheme. NAV is defined as the market value of the Mutual Fund scheme's assets net of its liabilities. NAV of a scheme is calculated by dividing the market value of scheme's assets by the total number of units issued to the investors.

2.4 Genesis of Mutual Funds

The idea of pooling money dates back to 1822, when groups of people in Belgium established a company to finance investments in national industries under the
name of ‘Societe Generale de Belgique’ incorporating the concept of risk sharing. The institution acquired securities from a wide range of companies and practiced the concept of mutual fund for risk diversification. The word ‘mutual’ denoted something to be done collectively by a group of people with the common objective of having mutual faith and understanding among themselves. ‘Fund’ was used in monetary terms, to collect some money from the members for a common objective like earning profits with joint efforts.

In 1822, King William I of Netherlands came up with a close-end fund. In 1860, this phenomenon spread to England. In 1868, the Foreign and Colonial Government Trust of London was formed, which was the real pioneer to spread risk of investors over a large number of securities and was considered as the Mecca of modern mutual funds. In 1873,

Robert Fleming established ‘The Scottish American Trust’. Although, many nineteenth century British investment trusts invested in American stocks, the first American investment trust was the close-end Boston Personal Property Trust created in 1893. In U.K., the accepting houses emerged as a major force in the business of investment management.

Mutual fund in America is basically the concept of Unit Trust of Britain. In U.S.A. mutual funds have come a long way since March 21, 1924 when the first fund, ‘Massachusetts Investment Trust’ was organised for the professors of Harvard University and offered shares to the public in 1926. But it was Sherman L Adams, the father of modern mutual fund, along with Charles Learoyd and Ashton Carr established a modest portfolio of 45 common stocks worth USD 50,000. The crash of stock

markets in 1929 led to the demise of many close-end funds. By 1930’s, 920 mutual funds were formed in U.S.A. and most of them were close end. In Canada, the Canadian Investment Fund was the first to be set up in 1932 followed by Commonwealth International Corporation Limited and Corporate Investors Limited.

The enactment of Securities Act of 1933, Investment Company Act of 1940 and Investment Advisors Act of 1940, led to the revival of mutual funds in U.S.A. The value of securities owned by U.S.A. funds was USD 2.5 billion in 1950. So, the accepting houses started rapidly to build up their skills and knowledge to deal with enlarged capital.

Since the World War-II, there had been a phenomenal growth in the mutual fund industry throughout the world. Mutual funds in Japan are known as investment trusts, but they differed from investment trusts of U.K. and mutual funds of U.S.A. While the growth of the mutual fund industry in U.S.A. was a spontaneous response to market developments, the Japanese investment trusts were established to meet the changing requirements of government policy and as such the establishment of investment trusts was a well thought-out action rather than a spontaneous response to economic market developments. The Mutual fund industry in Japan dates back to 1937. But an investment trust modelled on the unit trusts of U.K. was established only in 1941. Investment trusts in Japan were set up under the Securities Investment Law of 1951 with the three important characteristics namely contractual nature, open-end and flexibility.

Prior to 1960s, the U.S.A. provident fund professional investment authorities were abhorrent of investing in equities as they are of in India today. In 1980s, because of high mutual fund returns, employees (through IRA accounts) en masse shifted to equity option for their retirement fund. In stark contrast, Japan saw a 60 percent decline in Nikkei from 40,000 to 16,000 as a consequence of Japanese retail investors’ aversion
to equities. With the increasing inflation and interest rates during 1990’s, the individual and institutional investors became extremely sensitive to the true value of money. The shift started towards non-intermediation, resulting in the growth of mutual funds. In U.S.A., the number of mutual funds grew from 70 in 1940 to more than 3000 by the end of 1989. The mutual fund industry’s assets in U.S.A. increased from USD 44 billion in 1980 to USD 1 trillion in 1989. Subsequently hundreds of mutual funds, both open-end and close-end were launched and the concept of mutual funds spread over to many countries like Europe, the Far East, Latin America and Canada.

Retail investments in US mutual funds were low because of the flatness of the market from 1966 till 1982. The value of securities owned by U.S.A. fund houses increased from USD 60 billion in 1960 to more than USD 100 billion in 1983. Since the beginning of 1990, investors had poured over half a trillion dollars into stock and bond mutual funds.

In 1990, U.S.A. mutual fund industry constituted of 2,362 mutual funds with 39,614 thousands of investors holding USD 570.8 billion of assets. American investors embraced mutual funds with a fervour that even the most optimistic fund executives could not have predicted. By the end of 1994 in U.S.A., mutual funds had become the second largest financial institution after the banking sector holding assets worth USD 2161.4 billion. In 1995, U.K. equity income category had the highest number of account holders (11, 86,365)\(^{60}\)

The popularity of mutual funds among retail investors was further driven by changes in retirement fund investment norms where employees at large were allowed

to choose asset allocation between equities and debt. In December 1995, the European community issued a directive to coordinate laws, regulations and the administrative provisions relating to mutual funds and was popularly known as Undertakings for Collective Investment in Transferable Securities. The directive established a common regulatory scheme for investment policies, public disclosure, structure of organization, and regulations to encourage the growth of mutual funds all over the globe, which led the momentum in many countries in the Asia-Pacific region with a big bang, including Hong Kong, Thailand, Singapore and Korea.

The mutual fund in its present structure is a Twentieth Century phenomenon. Globally there were thousands of funds offering varied schemes with different investment objectives and options. Mutual funds emerged as the most important investment vehicle for household investments in U.S.A. with the basic objective of allowing small investors to partake in the capital market by investing in a wide portfolio of stocks so as to reduce risk. At the end of first quarter of 2003, the assets of worldwide mutual funds stood at USD 11.2 trillion while the assets of equity funds contributed for 35 percent as Exhibited in 2.1.

Chart 2.1

Composition of Worldwide Mutual Fund Assets
The number of worldwide mutual funds stood at 53,150 with equity funds accounting for 42 percent as shown in the chart 2.2.

Chart 2.2

Worldwide Number of Mutual Funds
As on March 2004, there were 8,212 mutual funds in U.S.A. totalling around USD 7.6 trillion where one out of every three investor held a mutual fund investment. In U.S.A., mutual funds outnumbered the securities on the New York Stock Exchange (NYSE). Mutual funds thus became a global financial culture, collectively managing more money compared to banks having a profound impact on financial markets.

### 2.4.1 Recent Trends in Mutual Fund Industry

With $13 trillion in assets, the U.S. mutual fund industry remained the largest in the world at year-end 2012. Total net assets increased $1.4 trillion from the level at year-end 2011, boosted by growth in equity, bond, and hybrid fund assets. Demand for mutual funds increased in 2012 with net new cash flows of all types of mutual funds totalling $196 billion. Investor demand for certain types of mutual funds appeared to be driven, in large part, by a continued trend toward investment diversification, the demographics of the U.S. population, and uncertainty surrounding the year-end fiscal cliff. Inflows to bond funds were quite strong and net withdrawals from equity funds.
picked up— their fifth consecutive year of outflows. Hybrid funds remained popular with inflows increasing again in 2012. After three years of sizable outflows, money market funds experienced a small net outflow of less than $500 million. This slowdown in net redemptions owed in large part to investors moving to cash at year-end because of fiscal cliff concerns.

2.4.2 Investor Demand for U.S. Mutual Funds-- Reasons

Investor demand for mutual funds is influenced by a variety of factors, not least of which is funds’ ability to assist investors in achieving their investment objectives. For example, U.S. households rely on equity, bond, and hybrid mutual funds to meet long-term personal financial objectives such as preparing for retirement. U.S. households as well as businesses and other institutional investors use money market funds as cash management tools because they provide a high degree of liquidity and competitive short-term yields. Changing demographics and investors’ reactions to changes in U.S. and worldwide economic and financial conditions play important roles in determining how demand for specific types of mutual funds and for mutual funds in general evolves over time.

2.4.3 Wall Street

Wall Street. Embodies a globally recognized, brand-name for investment firms that represent the mystique of rags-to-riches stories and paper fortunes won and lost. These big investment firms have deep pockets and impressive resources: big advertising budgets, big buildings and big marketing departments. They have thousands of employees, including research analysts and money managers -many of whom can be
spotted on CNN and CNBC commenting on the latest happenings in the stock market. Of course, big doesn't always mean better. Big companies are often impersonal. Employees come and go. Corporate mandates drive product sales decisions. The need to earn a quarterly profit to satisfy shareholders can translate into pressure to sell products, regardless of whether clients need those products. Proprietary products encourage conflicts of interest and huge numbers of brokers often translate into training programs geared to the lowest common denominator, resulting in cookie-cutter financial plans for all clients.

The consequence of becoming a large company is that smaller clients may get lost in the shuffle. Wall Street firms tend to overlook smaller clients and focus on their bigger clients who may have a net worth several times that of other customers. Losing one of these clients can seriously affect a broker's annual income. Also, many of the investment products that Wall Street offers - such as bonds, Treasury notes and private placements - are not even made available to small clients. Because of all these drawbacks for the small investor, if you're growing a portfolio, you may want to look to where your money is appreciated.

2.4.4 Main Street

A wide variety of investment advisors can be found on "Main Street" in cities and towns all across the country. Many of these independent advisors (they are independent because they are self-employed) have the flexibility to choose the products they offer and the freedom to act unencumbered by corporate policies or the needs of shareholders. Independent advisors often offer an impressive level of personal service because they have a stake in the business. As a client, you work directly with the owner.
2.4.5 Global Financial Crisis

Existing research shows that mutual fund flow is highly correlated with past performance in an asymmetric way, namely flow-performance convexity. Given such convex relationship, fund managers have incentives to manipulate fund characteristics to invoke future fund inflows. This study shows that mutual funds adopt a low risk strategy resulting in the greatest flow-performance sensitivity, which is convex. An incremental dampening effect is observed on flow-performance convexity due to increasing riskiness of portfolios, more significant in the GFC period but relatively less pronounced in the pre-GFC period. In addition, the results indicate that pure operating expense weakens the flow-performance sensitivity, especially in the post-GFC period. It is also found that front-end load is not a statistically significant variable in determining the flow-performance relationship. Nevertheless, back-end load on average dampens investor response to past performance and this dampening impact is more evident in the post-GFC period.

2.5 History of Mutual Fund Industry

In India the mutual fund concept took roots only in the sixties, after a century-old history elsewhere in the world. The idea of mutual fund took shape in India in 1963 with the setting up and enactment of the unit trust of India (UTI) by framing an Act titled the UTI Act. 1963 to operate both as a financial institution and an investment trust.

2.5.1 The Evolution

The formation of Unit Trust of India marked the evolution of the Indian mutual fund industry. 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 by dividing into following phases:

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

Unit Trust of India enjoyed complete monopoly when it was established 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 until the two were de-linked in 1978. Then the entire control was transferred to the Industrial Development Bank of India (IDBI). UTI launched its first scheme in 1964, named as Unit Scheme 1964 (US-64), which attracted the largest number of investors in any single investment scheme over the years.

UTI launched more innovative schemes in 1970s and 80s to suit the needs of different investors. It launched ULIP in 1971, six more schemes between 1981-84, Children's Gift Growth Fund and India Fund (India's first offshore fund) in 1986, Mastershare (India's first equity diversified scheme) in 1987 and Monthly Income Schemes (offering assured returns) during 1990s. By the end of 1987, UTI's assets under management grew ten times to Rs 6700 crores.

2.5.3 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 Canbank 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 crores. However, UTI remained to be the leader with about 80 per cent of the market share.
Table 2.1

Entry of Public Sector Funds

Source: AMFI website

<table>
<thead>
<tr>
<th>1992-93</th>
<th>Amount Mobilized</th>
<th>Assets Under Management</th>
<th>Mobilization as % of gross Domestic Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>UTI</td>
<td>11,057</td>
<td>38,247</td>
<td>5.2%</td>
</tr>
<tr>
<td>Public Sector</td>
<td>1,964</td>
<td>8,757</td>
<td>0.9%</td>
</tr>
<tr>
<td>Total</td>
<td>13,021</td>
<td>47,004</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

2.5.4 Phase III: Emergence of Private Sector Funds - 1993-96

Permission was 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. This measure had 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 had launched their schemes.

2.5.5 Phase IV: Growth and SEBI Regulations - 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.

Inventors” 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. It had 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 programmes 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.

In February 2003, the UTI Act was repealed and UTI was stripped of its special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. UTI was re-organized into two parts:

1. The Specified Undertaking
2. The UTI Mutual fund.

Presently Unit Trust of India operates under the name of UTI Mutual Fund and its past schemes (like US-64, Assured Return Schemes) are being gradually wound up. However, UTI Mutual Fund is still the largest player in the industry. In 1999, there was a significant growth in mobilization of funds from investors and assets under management which is supported by the following table.

Table 2.2

Gross Fund Mobilisation

(Rs. In Crores)

<table>
<thead>
<tr>
<th>Years</th>
<th>UTI</th>
<th>Public Sector</th>
<th>Private Sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998-1999</td>
<td>11,679</td>
<td>1,732</td>
<td>7,966</td>
<td>21,377</td>
</tr>
<tr>
<td>1999-2000</td>
<td>13,536</td>
<td>4,039</td>
<td>42,173</td>
<td>59,748</td>
</tr>
<tr>
<td>2000-2001</td>
<td>12,413</td>
<td>6,192</td>
<td>74,352</td>
<td>92,957</td>
</tr>
<tr>
<td>2001-2002</td>
<td>4,643</td>
<td>13,613</td>
<td>1,46,267</td>
<td>1,64,523</td>
</tr>
<tr>
<td>2002-2003</td>
<td>5,505</td>
<td>30,182</td>
<td>2,78,986</td>
<td>3,14,673</td>
</tr>
<tr>
<td>2003-2004</td>
<td>-</td>
<td>68,558</td>
<td>5,21,632</td>
<td>5,90,190</td>
</tr>
<tr>
<td>Year</td>
<td>Public Sector</td>
<td>Private Sector</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>------------</td>
<td>---------------</td>
<td>----------------</td>
<td>---------</td>
<td></td>
</tr>
<tr>
<td>2004-2005</td>
<td>1,03,246</td>
<td>7,36,416</td>
<td>8,39,662</td>
<td></td>
</tr>
<tr>
<td>2005-2006</td>
<td>1,83,446</td>
<td>9,14,712</td>
<td>10,98,158</td>
<td></td>
</tr>
</tbody>
</table>

Table 2.3

Assets under Management

(Rs. In Crores)

<table>
<thead>
<tr>
<th>As On</th>
<th>Public Sector</th>
<th>Private Sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-March-94</td>
<td>68,558</td>
<td>5,21,632</td>
<td>5,90,190</td>
</tr>
</tbody>
</table>

Source: SEBI Bulletin

Chart 2.3

Assets under the Management of the Indian Mutual Fund Industry

(Since 1964)
2.5.6 Phase V Growth and Consolidation - 2004 Onwards

The industry had also witnessed several mergers and acquisitions. They 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 had entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. This period was as a continuing phase of growth of the industry through consolidation and entry of new international and private sector players.

Indian mutual fund industry had an asset under management with a record high of Rs. 9.58 lakh crores in August 2013 and had remained near Rs. nine lakh crores at the end of the year. During March 2013, mutual funds saw a net outflow of Rs.1, 08,045 crores (of which Rs.84,002 crores outflow was from private sector mutual funds while

Source: www.amfiindia.com
public sector mutual funds saw an outflow of Rs. 24,044 crores). At the same time a net inflow of Rs.3, 584 crores (of which Rs. 3,769 crores inflow went to the private sector while public sector mutual funds saw an outflow of Rs. 185 crores) during February 2013. During the financial year 2013-14 so far, mutual funds net mobilised Rs. 76,098 crores as compared to Rs. 1,20,269 crores mobilized in corresponding period of 2012-13. The market value of assets under management stood at Rs. 8,25,840 crores as on December 31, 2013 as compared to Rs. 8,89,952 crores as on November 30, 2013, indicating a decrease of 7.2 percent during this month and an overall falling trend.

2.6 Functioning of Mutual Fund

Figure 2.3

Functioning of Mutual Fund
**Regulatory Authorities**

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 issued guidelines from time to time. MF either promoted by public or by private sector entities including one promoted by foreign entities is governed by these regulations.

SEBI approved Asset Management Company (AMC) manages the funds by making investments in various types of securities. Custodian, registered with SEBI, holds the securities of various schemes of the fund in its custody.

According to SEBI Regulations, two thirds of the directors of Trustee Company or board of trustees must be independent.

The Association of Mutual Funds in India (AMFI) reassures the investors in units of mutual funds that the mutual funds function within the strict regulatory framework. Its objective is to increase public awareness of the mutual fund industry.

AMFI also is engaged in upgrading professional standards and in promoting best industry practices in diverse areas such as valuation, disclosure, transparency etc.

**2.7 Existing Schemes in Mutual Fund Category: By Structure**

**2.7.1 Open - Ended Schemes**

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

**2.7.2 Close - Ended Schemes**
These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the Net Asset Value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the mutual fund through periodic repurchase at the schemes. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

2.7.3 Interval Schemes

Interval Schemes are that scheme, which combine the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

2.8 Types of Mutual Fund

The investment in mutual fund come in six broad categories viz., Equity Funds, Money Market /Liquid Funds, Hybrid Funds Debt/ Income Funds, Gilt Funds and Others With in each of these broad categories there are several sub variants as follows:

i) Equity funds

- Aggressive growth funds
- Growth funds
- Equity income or dividend yield
- Diversified equity funds (ELSS)
- Equity index funds
- Value funds
- Speciality funds
  a) Sectors funds
  b) Foreign securities funds
  c) Mid-cap/ small-cap equity funds
  d) Option income funds

ii) Money market / liquid funds

iii) Hybrid funds
  - Balanced funds
  - Growth-and income funds
  - Asset Allocation Funds

iv) Debt / Income funds
  - Diversified debt funds
  - Focused debt funds
  - High yield debt funds
  - Assured return funds
  - Fixed term plan series

v) Gilt funds
vi) Others

- Commodity funds
- Real estate funds
- Exchange traded funds (ETFs)
- Funds of funds

2.9 Operation of Mutual Funds

The mutual fund has been operating for about fourteen years, now thus; it is too early to evaluate its operations. The following are some of the shortcomings in the operation of mutual funds:

- All mutual funds are externally managed. They do not have employees of their own. Also, there is no specific law to supervise the working of mutual funds in India. There are multiple regulations. While UTI is governed by its own regulations, the banks are supervised by Reserve Bank of India and the Central Government. The insurance company mutual funds are regulated by Central Government Regulations.

- Many of the investors are not willing to invest in mutual funds unless there is an assurance of a minimum return.

- Many small companies have done very well but mutual funds cannot reap their benefits because they are not allowed to invest in smaller companies not only this, mutual funds are allowed to hold only a fixed maximum percentage of shares in a particular industry.

- An increase in the number of mutual funds under various schemes had increased competition. As a result, they lose their stabilising factors in the markets.
The mutual funds are formed as trusts. There is no distinction made between sponsors, trustee and fund managers. The trustees play the role of fund managers.

India is a vast country with a comprehensive demographic profile. But mutual funds are still confined to urban and semi-urban markets. Moreover, mutual funds till now have not been able to introduce schemes that are suitable to the needs of agricultural farmers, small entrepreneurs and merchants to tap the rural savings.

Investor relations play a vital role in mobilizing resources. Most Indian companies and mutual funds have ignored this and have failed to communicate to the investors about their organization and operations.

Unlike banks, mutual funds do not have a strong distribution network.

Apart from a few, most have to depend on broker networks.

Long term capital gains have been reduced from 20% with indexation benefits to 10% without indexation. But this is available only to securities, which is under section 112 of the Income Tax Act. For mutual funds it is an edge for the listed funds.

There is a restriction on corporate investments up to a maximum of, 60% of net worth for mutual funds. But there is no such stipulation for bank fixed deposits and gilt securities.

The cheque writing facility is available only to the money market mutual fund investors. Thus, mutual funds cannot issue a cheque on behalf of another bank.

The development of mutual fund industry depends upon the maturity of the merchant banking industry. But unfortunately, the merchant banking industry in the Indian capital market is not sufficiently matured.
• The most important aspect for the success of a mutual fund is the ability to outsource certain critical activity. This concept is already prevalent in manufacturing. But it has been introduced in fund management.

• The Internet and e-commerce which are indispensable nowadays have still not been introduced in mutual funds in huge way.

2.10 Types of Returns and Risk

There are three ways, where the total returns provided by mutual funds can be enjoyed by investors:

• Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all income it receives over the year to fund owners in the form of a distribution.

• If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.

• If fund holdings increase in price but are not sold by the fund manager, the fund's share price rises. Then the shareholder can then sell his mutual fund shares for a profit. Funds will also usually give the shareholder a choice either to receive a check for distributions or to reinvest the earnings and get more shares.

Chart 2.4
The risk return trade-off indicates that if investor is willing to take higher risk, then correspondingly he can expect higher returns and vice versa. If he pertains to lower risk instruments, he would be getting lower returns. For example, if investors opt for bank FD, it would provide moderate return with minimal risk. But if he moves ahead to invest in capital protected funds and the profit-bonds that give out more return compared to the bank deposits. But the risk involved also increases in the same proportion.

Thus investors choose mutual funds as their primary means of investing, as mutual funds provide professional management, diversification, convenience and liquidity. That doesn’t mean mutual fund investments are risk free. This is because the money that is pooled in is not invested only in debts funds which are less risky but are also invested in the stock markets which involves a higher risk but can expect higher
returns. Hedge fund involves a very high risk since it is mostly traded in the derivatives market which is considered very volatile.\textsuperscript{61}

2.11 Advantages of Mutual Funds

2.11.1 Diversification

A sound investment policy is based on the principles of diversification. By investing in many companies the mutual funds can protect themselves from unexpected drop in value of some shares. The small investor cannot achieve wide diversification on his own because of many reasons mainly that of limited funds at his disposal. Mutual funds on the other hand, pool funds of millions of investors and thus can participate in a large basket of shares of many different companies.

2.11.2 Professional Management

When an investor buys a mutual fund scheme, an essential benefit he acquires is expert management of the money he puts in the fund. The professional fund managers who supervise fund’s portfolio take desirable decisions like what shares are to be bought, what investments are to be sold etc.

2.11.3 Diversification of Risk

When an investor invests directly all the risk of potential loss is his own, whether he places a deposit with a company or a bank, or buys a share or debenture on his own. While investing in mutual funds the potential losses are shared with other investors.

\textsuperscript{61} http://www.indiastudychannel.com/projects/666-A-STUDY-ON-MUTUAL-FUNDSIN INDIA.aspx
2.11.4 Safety of Investment

Investors in mutual funds receive adequate protection from regulatory agencies. Mutual funds submit several reports to these agencies and also are required to publish details of their operations for public information.

2.11.5 Liquidity of Investment

Mutual fund investors can generally encash their investment at any time, by selling their units to the fund if open-ended, or selling them in the market if the fund is close-ended. Liquidity of investment is clearly a big benefit.

2.11.6 Tax Benefit

Many mutual funds provide tax shelter. In India, equity linked schemes of mutual fund allowed tax rebate under sec.88 and tax exemption on mutual fund dividend under Sec. 80L.

2.11.7 Low Operating Cost

Mutual funds having large investible funds at their disposal avail economies of scale. The brokerage fee or trading commission may be reduced.

2.11.8 Switching

Mutual funds provide flexible investment opportunities to investors. Investors can switch over from the one fund to another. Investing in securities through mutual funds has many significant advantages over organization of a personal portfolio.\textsuperscript{62}

2.12 Importance of Mutual Funds

\textsuperscript{62} Sharpe, Willian F. and Alexander Gordan J., “Investments”, Prentice Hall of India, New Delhi, 1994, p.205-210
Owing to the size, operating economics and the ability to commit large sums of money for long periods, mutual funds enjoy ample resources at their disposal by mobilizing from many investing public. Mutual funds with the expertise and experienced management cadre can secure large varieties of high yielding – “Blue chip” securities and show better results to the investing public. Therefore, investors are now for investing their resources in various mutual fund schemes, in preference to managing themselves. Nowadays mutual funds are gaining popularity due to the following reasons:

- The basic purpose of reforms in the financial sectors was to enhance the generation of domestic resources by reducing dependence on outside funds. This calls for a market-based institution, which can tap the vast potential of domestic savings and channelize them for profitable investments. Mutual funds are not only best suited for the purpose but also capable of meeting this challenge.

- An ordinary investor who applies for shares in a public issue of any company is not assured of any firm allotment. But mutual funds, those especially subscribing to the capital issue made by companies get firm allotment of shares. Mutual funds later sell these shares in the share market and to the promoters of the company at a much higher price. Hence mutual fund creates investor confidence.

- The psyche of the typical Indian investors has been summed up in three words viz., -- yield, liquidity and security. The mutual funds being set give an impression of being as safe a conduit for investment as bank deposits. Besides, the assured returns promised by them have been great for Indian investors.
As mutual funds are managed by professionals, they are regarded as having a better knowledge of market behavior. Besides, they bring a certain competence to their job. They also maximize gains by proper selection and timing of investments.

Another important thing is that the dividend and capital gains are reinvested automatically in mutual funds and hence are not frittered away. The automatic reinvestment nature of a mutual fund is a form of forced saving and can make a big difference in the long run.

The mutual fund operations provide reasonable protection to investors. Besides, presently all schemes of mutual funds provide tax relief under section 80 (I) of the Income Tax Act. In addition to this, some schemes provide tax relief under Section 88 of the Income Tax Act leading to the growth of mutual funds.

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

In view of the recent liberalized economic and industrial policies and concessions, the capital market-both the primary and secondary issue markets have been witnessing unprecedented booming trends. Hence mutual funds have been able to spread their wings by disbursing their funds amongst various industrial sectors.

Risk of loss due to ill-informed and misinformed purchase /sales is reduced as managers of mutual funds have better access to information. Risks are reduced
due to diversification of portfolios in terms of companies and industries. Even small investors in mutual funds obtain the benefits of diversification.

- Lastly, another notable feature is that mutual funds are controlled and regulated by SEBI and therefore considered safe. Due to all these advantages, the importance of mutual funds has been increasing.

### 2.13 Recent Developments in Mutual Funds Marketing

The mutual funds industry gradually started taking new initiatives in order to adapt to the emerging market environment. The measures taken to improve marketing include widening the product basket, enlarging the chain of product placement and improved disclosure with respect to the product. The offer documents have become more structured and contain information relating to service and management. The use of technology for communication selling and servicing has also improved the marketing of mutual funds. All this had resulted in better protection for investors now than in the early 1990s. Further, as a result of the competition arising from the entry of private sector mutual funds, investors now have a wider choice in terms of products, costs and management style. The media is also playing a very active role in disseminating information—by encouraging debate and focusing on the performance of mutual funds, it is facilitating the process of informed decision-making by investors.

Given all these factors, today’s investor is far more enlightened performance oriented and assertive. In addition, the prudential regulations implemented by SEBI, which are in many respects comparable to the best in the world, have enhanced the accountability of AMCs and their directors, as well as the trustees of funds. There has thus been a significant transition and the market has become considerably more mature.
The other developments include the introduction of training and self-regulations for marketing personnel and the programme for investors’ education, both initiated by the Association of Mutual Funds in India (AMFI). More significant, however, is SEBI’s Marketing code for mutual funds, which has made mutual funds marketing a more regulated and disciplined activity, more alert to the investor’s rights and expectations.\textsuperscript{63}

2.14 Emerging Issues in Mutual Funds

2.14.1 Rating of Mutual Fund Schemes

Total return has been the criteria for measuring the performance of mutual funds. Therefore, Credit Rating Information Services of India Limited (CRISIL) has developed a composite performance ranking which measures performance for each of the open-ended schemes. Which are at least two years old and disclose 100% of their portfolios.

2.14.2 Change in MF industry due to the advent of net

Mutual funds could bring down their administrative costs to 0.75 per cent if trading is done online and consequently improves the return potential of their schemes. Mutual funds could provide between advice and service to their investors through the net.

2.14.3 New Norms on NPA Classification

The Melegan Committee has recommended that debt securities held by mutual funds in their portfolio can be classified as NPA.

2.14.4 Influence of technology

A majority of the mutual funds have their own websites providing basic information relating to the schemes. Mutual funds have begun to use electronic fund transfer method to remit their dividends and redemption proceeds.

2.14.5 Product Innovation

Product innovation is an emerging feature in the mutual fund industry in India. Most of the products offered by mutual funds can be divided among three classes viz., cash funds, income funds and equity funds.

2.14.6 Indices for Mutual Funds

The AMFI has launched in 2013, four indices for gilt funds and another set of indices for balanced funds, bond funds monthly income plans and liquid funds. The indices, which have been developed, will be maintained by ICICI securities and finance companies and CRISIL. Com respectively will be mandated for use by mutual funds to enable the comparison of performance.64

2.15 Conclusion

Beginning from the four basic components of the India financial system this chapter has defined the mutual fund, traced its history and analyzed the concept of mutual funds. An explanation of the functioning of the mutual fund, its operation, and the various returns obtained and broad mutual fund types, the chapter closes with presentation of emerging issues in mutual funds in India. The resultant advantage has been found out with the point that the investors have now developed more confidence and trust in the stock market functioning.

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