CHAPTER 3

THE MUTUAL FUND INDUSTRY IN INDIA

3.1 INTRODUCTION

India is one of the fastest growing economies in the world. With the liberalization policy adopted by the Government of India since 1991, the financial system of
India has been redefined and today in spite of the economic slowdown, the Indian Financial System is considered sound and stable. India has been ranked as one of the fastest growing economy in the world. If the predictions of the experts are to be right, then India is likely to emerge as the third pole in the global economy, after U.S and China. All this could be possible only with a sound financial system in the country. The Indian Mutual Fund Industry has assumed great significance over the past decade and is an important segment of the financial markets in India. With the growing economy, the investor’s disposable income in the hands of the investors also increases with more scope for saving. Today the avenues of investment are also on the rise, ranging from investment in shares, debt instruments, real estate, insurance, bank deposits, and mutual funds, etc. The share market is highly volatile and the chances that an investor lose money is also high as the common investor is unaware of the nuances of stock trading and its price movements and hence high risk and uncertainty. The concept of risk and uncertainty is a major deterrent to the investor though he/she expects high returns and wants to benefit from the stock market. As the financial market has become highly sophisticated and complex, a good alternative to direct investment and the most appropriate investment opportunity for small investors would be the mutual fund.

Since the emergence of Mutual fund in India in 1963, the industry has seen many changes. After the Economic Liberation in 1991, the mutual fund industry saw the entry of commercial banks and private players (both domestic and foreign). This led to rapid growth and competition in the industry with every Asset Management Company (AMC) coming up with new schemes. As of June 2014 AMFI data, there are 45 AMCs in India which includes the commercial banks, institutions,
private and foreign players with the Average Asset Under Management being Rs. 9,87,240 crores.

The retail segment investor in India who comprise nearly 98 percent of the investor account, constitute only 20 percent of the total net assets and the corporate and institutions constitute nearly 53 percent. This retail segment is significant as only 8 percent of the household financial saving population invests in mutual funds in India, thereby providing a vast scope for the industry to engage this segment and expand. The following literature focuses on this segment of investors and makes an attempt to understand broadly the mutual fund industry in India, the major stakeholders of the industry, the challenges and perceptions of the retail investor and prospects for the fund houses to expand their base in the current globalised context.

3.2 THE CONCEPT OF MUTUAL FUND

A Mutual Fund is a financial Intermediary which serves as a link between the investor and the security market by mobilizing the savings from the investor and investing them into the securities market to generate returns. According to the Security Exchange Board of India (Mutual Fund's) Regulations Act of 1996, Mutual Fund is ‘a trust to raise money through sale of units to public or a section of the public under one or more schemes for investing in securities, including money market instruments’
It is a product designed to target small investors who are not comfortable with the stock market, however want to reap the benefits of investing in stock market. A mutual Fund uses the money collected to buy those assets that are specifically stated in the investment objective. The funds assets are owned by the investors in the same proportion as their contribution bears to the total contribution of all investors put together. In the U.S., a mutual fund is constituted as an Investment Company and an investor ‘buys into the fund’ which means he buys the shares of the fund. In India the mutual fund is constituted as a Trust and the investor ‘subscribes to the units of the fund’.

Professional money managers use the pool of money to buy a variety of stocks, bonds or money market instruments that in their judgement will help the fund’s shareholders achieve their stated financial objectives.

According to Dian Vujovich, a mutual fund wouldn’t be a mutual fund without things such as

- A reason for the fund, i.e. its objective
• A variety or combination of stocks, bonds and other types of securities to put it into the investment company i.e. some diversification of investment
• A portfolio manager or management team for professional management
• A way for everyone to know the value of investment., i.e. daily pricing of securities within the fund
• A way for investors to get their hands on a portion of the money they have invested i.e., the ability to buy and sell shares of the fund daily

3.2.1 Benefits In Investing In Mutual Funds
Mutual fund is a favoured investment vehicle, because it offers many advantages over other form of investing avenues. Some of the major advantages are discussed below.

• Affordability: Mutual funds allow you to start with small investments because it collects money from many people and it has a large corpus.

• Portfolio Diversification: Mutual Funds invest in a well diversified portfolio of securities which reduces the risk on returns to the investors. The investor may not be able to have a diversified portfolio on his own given his capital and lack of detailed research and capital monitoring.

• Professional Management: The funds are managed by professional fund managers who have an understanding and expertise backed by research into the available investment options, which the investor cannot manage on his own.

• Reduction of Transaction Cost: A direct investor has to bear cost such as brokerage or custody of securities, which would cost high to the investor, compared to the investment being made through the fund which can pass on the benefits of economies of scale to the investor
• **Flexibility and convenience:** Mutual Fund Houses offer various services to the investors. He/she can transfer/switch their holdings from one scheme to another; they can withdraw their money at regular intervals in most open ended schemes. Further they get to sell their units through the internet, e-mails etc., All this offers flexibility and convenience to the investor.

• **Liquidity:** This is one of the main advantages of investing in mutual funds. Open ended schemes offer liquidity through on-going sale and repurchase facility.

• **Tax Efficiency:** Mutual Fund Schemes do not pay any tax on their income, so the same earning in a mutual fund scheme could facilitate a higher reinvestment.

### 3.3: A BRIEF HISTORY OF MUTUAL FUNDS IN INDIA

The mutual fund industry in India has its origin in 1963, with the formation of UTI (Unit Trust of India), with the initiative of the GOI & Reserve Bank of India. The growth of Mutual Fund in India can be described in the following four phases:

**The first Phase**

In the first phase it was only UTI which was established by the Act of Parliament in 1963 and was administered and regulated by the RBI. In 1978, UTI was delinked from RBI and IDBI took over the administrative and control aspects. By 1988 UTI had Rs. 6700 crores of assets under management.

**The second phase – Entry of public sector funds**


**The Third Phase – Entry of private sector Funds**

With the liberalization of the Indian Economy in 1992, Mutual Fund industry found the entry of Private/ Foreign Players. Former Kothari Pioneer was the first private AMC to register in 1993, followed by the others. At the end of January 2003 the Total Assets Under Management stood at Rs. 1,21,805 Crores.

**The Fourth Phase – since 2003**

The UTI Act of 1963 was repealed. The UTI was bifurcated into two entities. Specified Undertaking of UTI with assets under management of Rs.29,835 crores at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations

3.4 GROWTH IN ASSET UNDER MANAGEMENT IN RECENT YEARS.
The AUM as on September 2013 is approximately 8,140 billion as in figure 3.4. The industry, after several years of persistent growth has shown relatively slow growth since 2010, with a CAGR of approximately 3.2 percent. Lack lustre stock market performance, rise in inflation and anticipation in rise in interest rates have been seen as the reason for slow growth in recent years.

Market Share Of Leading Mutual Funds As On September 2013
The AUM’s penetration as a percent of GDP is around 6 percent, whereas it is 77 percent in the US 40 percent in Brazil and 31 percent for south Africa (kpmg 2013). The public sector has gradually ceded market share to the private sector. The industry is highly concentrated and approximately 80 percent of the market share is with top 10 players in the industry. The mutual fund market leaders have focused across product categories for a more diversified AUM base with an equitable product mix that helps maintain a consistent AUM size. Although the Indian market has relatively low entry barriers given the low minimum net worth required to venture into mutual fund business, existence of a strong local brand and a wide and deep distribution footprint are the key differentiators. The market
share of the mutual fund players is shown in the diagram below. The HDFC Mutual Fund (13 percent), Reliance Mutual Fund (12 percent), ICICI Prudential Mutual Fund (10 percent), UTI Mutual Fund (9 percent) and Birla Sun Life Mutual Fund (9 percent) are the major players in the industry.

3.5 STRUCTURAL CLASSIFICATION

Mutual funds are broadly classified as (1) Open Ended Schemes and (2) Close Ended Schemes

Open Ended Schemes – In case of Open Ended Schemes, the funds continuously offer to sell and repurchase its units on Net Asset Value (NAV). They need not be listed on the Stock Exchange. Investors can exit and enter the schemes anytime during the life of the fund. There is no fixed redemption period in open ended schemes, which can be terminated whenever the need arises.

Close Ended Schemes – Close Ended schemes have a fixed corpus and a stipulated maturity period ranging between 2 to 5 years. Investors can invest in the scheme when it is launched. Shares are sold at an initial offering and are then traded over the counter market like common stock.

3.5.1 Classification Based On The Objectives Of The Investment

Equity Funds: Equity funds are for investors with high risk appetite. Investors and their advisors need to choose the right equity fund that suits their risk appetite. There are different types of equity funds with slightly different risk profile. They normally invest most of their corpus in equity shares issued by the companies, acquired directly in initial public offerings or through the secondary market. Equity funds are exposed to the equity price fluctuation risk at the market level,
industry or sector level and at the company-specific level. Equity Funds NAV fluctuates with all these price movements. The issuers of equity share do not offer guaranteed payment as in the case of debt funds. Hence generally equity funds are considered to be on the higher end of the risk spectrum among all funds available in the market. On the other hand, equity funds can appreciate in value in line with the issuer’s earning potential and so offers the greatest potential for growth in capital. Equity funds are generally separated into different types in terms of their investment styles. They are as follows

- **Aggressive Growth Funds**: As the name suggests, aggressive growth funds target maximum capital appreciation, invest in less researched or speculative shares and adopt speculative investment strategies to attain their objective of high return to the investors. So they obviously tend to be more volatile and riskier than other funds.

- **Growth Funds**: Growth funds invest in companies whose earnings are expected to rise at an above average rate. These companies may be from sectors like technology considered having a growth potential, but not entirely unproven or speculative. The primary objective of growth funds is capital appreciation in three to five years. These are considered to be less volatile and riskier than the aggressive growth funds.

- **Specialty funds**: These funds have a narrow portfolio orientation and invest only in companies that meet pre-defined criteria. Within the specialty funds some may be broad based in terms of types of investment in the portfolio. However most specialty funds tend to be in concentrated funds since diversification is limited to one type of investment and hence tend to be more volatile than diversified funds. These specialty funds could be.
• **Sector Funds**: Such funds consist of investments in only one industry like information technology, pharmaceuticals, Fast Moving Consumer Goods etc. Since sector funds do not diversify into multiple sectors, they carry a higher level of sector and company specific risk than diversified equity funds.

• **Foreign Securities Funds**: These funds invest in equities in one or more foreign countries thereby achieving diversification across the country’s borders. However, they also have additional risks such as the foreign exchange risk and their performance depends on the economic conditions of that country.

• **Mid-Cap or Small-Cap Equity Funds**: These funds invest in shares of relatively lower market capitalization than that of big Blue Chip companies. They may thus be more volatile than other funds, as mid-size smaller companies shares are not very liquid in the markets. These are a kind of specialty funds. In terms of risk characteristics, small company fund may be aggressive growth or just growth type funds.

• **Income funds**: As the name suggests, the aim of these funds is to provide regular and steady income to investors. They generally invest their corpus in fixed income securities like bonds, corporate debentures, and government securities. Income funds are ideal for those looking for capital stability and regular income.

• **Balanced funds**: The objective of balanced funds is to provide growth along with regular income. They invest their corpus in both equities and fixed income securities as indicated in the offer documents. A Balanced Fund is one that has a portfolio comprising debt instruments, convertible securities, and preference and equity shares. Their assets are generally held in more or less equal proportion in the overall portfolio of debt or equity.
funds. However, these funds are relatively balanced and are ideal for those looking for income and moderate growth. Most suitable for investors with a conservative and long term orientation

- **Money Market Funds:** These funds strive to provide easy liquidity, preservation of capital and modest income. Money Market Funds generally invest the corpus in safer short-term instruments like treasury bills, certificates of deposit, commercial paper and inter-bank call money. Often considered to be at the lowest rung in the order of risk level. Returns on these schemes hinges on the interest rates prevailing in the market. Though interest rate risk is present, the impact is low as the investment instruments maturities are short. MMFs are ideal for corporate and individual investors looking to part funds for short periods.

- **Tax saving schemes:** Tax Saving Schemes or Equity-Linked Savings Schemes offer tax rebates to investors under section 88 of the Income Tax Act. They generally have a lock-in period of three years. They are ideal for investors looking to exploit tax rebates as well as growth in investments.

- **Index funds:** Index Funds invest their corpus on the specified index such as BSE Sensex, NSE index, etc. as mentioned in the offer document. They try to mimic the composition of the index in their portfolio. Not only the shares, even their weightage is replicated. Index funds are a passive investment strategy and the fund manager has a limited role to play here. The NAVs of these funds move along with the index they are trying to mimic save for a few points here and there. This difference is called tracking error.

- **Exchange Traded Funds (ETF):** An Exchange Traded Fund is a mutual fund scheme, which combines the best features of open end and close end structures. It tracks a market index and trades like a single stock on the
stock exchange. Its pricing is linked to the index and units can be bought and sold on the Stock exchange. ETF offers the investor the benefit of holding a single share as well as the diversification and cost efficiency of an index. These fund are very popular abroad and have been introduced in India too.

- **Real Estate Funds**: Specialized Real Estate Funds would invest in real estate directly, or may fund real estate developers, or lend to them, or buy shares of housing finance companies or may even buy their securitized assets. The funds may have a growth orientation and may seek to give investors a regular income.

- **Fund of Funds**: A Fund of Funds invest in other mutual funds. Just as a normal mutual fund invests in a portfolio of securities such as debt or equity, a fund of fund invests in a portfolio of units of other mutual fund schemes. Availability of a fund to an investor helps him select the right funds from a wide variety of schemes offered by different asset management companies.

It also helps the investor, to diversify his risk not only in terms of securities held in his portfolio, but also enjoys diverse management styles. The risk level associated with this types of fund is generally lower than the other type of conventional mutual fund schemes.

### 3.6: THE ASSET MANAGEMENT COMPANIES (AMC)
The Asset Management Companies act as Investment Manager of the Trust. The Sponsors or the Trustees, if so authorized by the trust deed, appoint the AMC. Once appointed, it has to be approved by the SEBI and then functions under the supervision of its own Board of Directors, and also under the direction of the Trustees and SEBI. The Trustee is empowered to terminate the appointment of the AMC with the prior approval of SEBI and unit holders.

The AMC would in the name of the Trust, float and manage the different investment ‘schemes’ as per SEBI Regulations and as per the Investment Management Agreement it signs with the trustees. Chapter IV of SEBI Mutual Funds Regulation of 1996 describes the issues relevant to appointment, eligibility criteria, restrictions on business activities and obligations of AMC.

The directors of AMC both independent and non-independent should have adequate professional experience in financial services and should be individuals of high moral standing, a condition also applicable to other key personnel of AMC. The AMC cannot act as a trustee of any other mutual fund. The AMC should always act in the interest of the unit holders and report to the trustees with respect to its activities.

### 3.6.1 Obligation of the AMC and its Directors

The AMC and its Directors should ensure that,

- Investment of funds is in accordance with SEBI Regulations and Trust Deed
- They take responsibility for the acts of its employees and others whose services it has procured
- They are answerable to the trustees and must submit quarterly reports to them on AMC activities and compliance with SEBI regulations
• If the AMC uses the services of a sponsor, associate or employee, it must make appropriate disclosure to unit-holders including the amount of brokerage or commission paid

• They do not undertake any other activity conflicting with managing the fund

• They will float schemes only after obtaining the prior approval of Trustees and SEBI

• They will make the required relevant disclosures to the investors in all the areas of AMC operations as stipulated by SEBI such as calculation of NAV, sale and repurchase price, portfolio details, half yearly accounts of funds etc.,

• Each day’s NAV is updated on AMFI’s website by 8:00 p.m. of the relevant day and the month-end Asset Under Management figure on the first working day of the next month

• Any ongoing open-ended scheme proposing to launch additional plans other than dividend and growth plans, will be launched as separate schemes, if they differ from the main scheme in terms of portfolio, maturity or any other characteristics. They may however be launched as part of the existing offer document by issuing an addendum subject to each such Plan following all disclosure requirements prescribed by the Regulations

• In the event of merger or consolidation of schemes the unit holders are intimated through a letter giving them the option to exit at the prevailing NAV without exit load and all other relevant information is disclosed enabling them to take well informed decisions.

3.7: ROLE OF REGULATORY ORGANISATIONS
When we speak of the Legal and the Regulatory environment in the Indian Mutual Fund Industry, the capital market regulator SEBI, the RBI, the Ministry of Finance, the Company law Board, the Stock Exchange, the Association of Mutual Funds in India etc., with their guidelines and regulations facilitate the smooth functioning of the Fund houses and safeguard the interests of the investors. While institutions like the SEBI and RBI have legal powers, Self Regulatory Organizations like the Stock Exchange, do not. This section briefly touches upon the role of these regulatory organizations in setting up a fund and regulating its operations.

3.7.1: Role Of Self Regulatory Organisations

Agencies like the Reserve Bank of India & the Securities Exchange Board of India (SEBI) are regulators with legal powers to set rules and enforce them on market participant over whom they have jurisdiction. At times the regulator grants power to the market participants for self regulation. A stock exchange is an entity that can regulate its own broker members in a certain limited way under the overall regulatory supervision of SEBI.

Self- Regulatory Organisation (SRO)

A Self Regulatory Organisation is an association representing a group of market participants which is specially empowered by the apex regulatory authority to exercise pre-defined authority over the regulation of their members. Stock Exchanges in most countries are granted the status of Self Regulatory Organisations.

3.7.2 Role of Association of Mutual Fund Industry in India (AMFI)
AMFI is the apex body of all registered Asset management Companies. It was incorporated on August 22, 1995 as a non-profit organisation. As of now all the 39 Asset Management Companies, that are registered with SEBI are its members. AMFI functions under the supervision and guidance of a Board of Directors.

Association of Mutual Funds India has brought down the Indian Mutual Fund Industry to a professional and healthy market with ethical lines enhancing and maintaining standards. It follows the principle of both protecting and promoting the interests of mutual funds as well as their unit holders.

It has certain defined objectives which juxtaposes the guidelines of its Board of Directors. **The objectives are as follows:**

This mutual fund association of India maintains a high professional and ethical standards in all areas of operation of the industry.

- It also recommends and promotes the top class business practices and code of conduct which is followed by members and related people engaged in the activities of mutual fund and asset management. The agencies who are by any means connected or involved in the field of capital markets and financial services also involved in this code of conduct of the association.
- AMFI interacts with SEBI and works according to SEBI’s guidelines in the mutual fund industry.
- Association of Mutual Fund of India do represent the Government of India, the Reserve Bank of India and other related bodies on matters relating to the Mutual Fund Industry.
- It develops a team of well qualified and trained Agent distributors. It implements a programme of training and certification for all intermediaries and other engaged in the mutual fund industry.
- AMFI undertakes all India awareness programme for investors in order to promote proper understanding of the concept and working of mutual funds.
• At last but not the least association of mutual fund of India also disseminate information on Mutual Fund Industry and undertakes studies and research either directly or in association with other bodies.

From time to time, AMFI sets up committees review and evolve standards for the mutual fund industry on different aspects of mutual fund management or investor relations. For example, one committee has examined the question of security valuation norms in determining the NAV of a fund. Another has devised an Advertising Code for its member funds. There is a committee on Best practices in Industry, including one that looks at Risk Management practices for the fund. The AMFI Code of Ethics is already an accepted standard in the industry.

Though AMFI is technically not a Self Regulatory Organisation, it does perform certain self regulatory functions. For example, it does register the fund distributors, test and certify their competence, and has powers to deny registration to distributors for failing the test for violating AMFI Code of Conduct. It has also undertaken the cause of training the mutual fund distributors as well as educating the investors about the benefits and risk of mutual fund investing.

3.7.3 Role Of Securities Exchange Board Of India (SEBI)

The Government of India constituted the Securities Exchange Board of India by an Act of the Parliament in 1992 as the apex regulator of all entities that either raise funds in the capital market or invest in capital market securities such as shares and debentures listed in stock exchanges. The objectives of SEBI are – to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

Mutual fund being an important institutional investor in the capital market comes under the purview of SEBI and SEBI requires all Mutual Funds to be registered
with them. It issues guidelines for all mutual fund operation including where they can invest, what investment limits and restrictions must be complied with, how they should account for income and expenses, how they should make disclosures of information to the investors and generally act in the interest of investor protection.

SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

### 3.7.4 The Regulatory Framework And Their Protective Measures

In terms of the regulatory framework in the Indian Mutual Fund Industry, it is believed to match up with the most developed markets globally. SEBI has consistently introduced several regulatory measures and amendments aimed at protecting the interests of the small investor that augurs well for the long term growth of the industry.

The Implementation of *Prevention of Money Laundering (PMLA) Rules*, as part of the risk management practices and procedures is expected to gain further momentum. The current *Anti Money Laundering (AML) and Combating*
Financing of Terrorism (CFT) measures cover two main aspects of Know Your Customer (KYC) and ‘suspicious transaction monitoring and reporting’.

The regulatory and compliance ambit seeks to dwell on a range of issues including the financial capability of the players to ensure resilience and sustainability through increase in net worth and capital adequacy, investor protection and education through disclosure norms for more information to investors, distribution related regulations aimed at introducing more transparency in the distribution system by reducing the information gap between investors and distributors, and by improving the mechanism for distributor remuneration.

The success of the relatively nascent mutual fund industry in India, in its march forward, will be contingent on further evolving a robust regulatory and compliance framework that in supporting the growth needs of the industry ensures that only the fittest and the most prudent players survive.

3.8: HOW IS A MUTUAL FUND SET UP?

A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company (AMC) and custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities.

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.
SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.

3.9: NET ASSET VALUE (NAV)

The performance of a particular scheme of a mutual fund is denoted by Net Asset Value (NAV). Mutual funds invest the money collected from the investors in securities markets. In simple words, Net Asset Value is the market value of the securities held by the scheme. Since market value of securities changes every day, NAV of a scheme also varies on a day to day basis. The NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on any particular date. For example, if the market value of securities of a mutual fund scheme is Rs 200 lakhs and the mutual fund has issued 10 lakhs units of Rs. 10 each to the investors, then the NAV per unit of the fund is Rs.20. NAV is required to be disclosed by the mutual funds on a regular basis - daily or weekly - depending on the type of scheme.

3.10: THE RETAIL INVESTOR

According to the KPMG & CII survey of 2013, the Indian Asset Under Management industry is likely to grow in the range of 12 – 15 percent for the period FY14 – FY19 driven by increasing volumes from retail investors, driven by overall increase in investor awareness and enhanced distribution reach. Increase in disposable income and household financial savings has resulted in household seeking alternative avenues of investment to yield higher returns and reasonable risk. But the question arises as to what is the total share of this retail investor
contribution in the mutual fund industry and is the mutual fund a sought after investment? Though the data point to the growth of this section of investor, it is not at a satisfactory level, compared to the mature markets like the US or the emerging markets like Brazil and China. So this section focuses on understanding the retail investor’s environment in the context of current global developments in India, their perspectives, the major challenges faced by them and the reason for its slow growth.

3.10.1 Key Characteristics of Indian Mutual Fund Investors

- As per the latest data available, the retail investor, comprise more than 97 percent in number of accounts and holds 20 percent of the total industry’s AUM as on September 2013 data. This is significantly lower when compared to the retail participation in the United States which stands more than 77 percent of the total Asset Under Management.
- As per the Invest India Incomes and Savings Survey of 2007, of individual wage earners in the age group 18 to 59 years conducted by IIMS dataworks, only 1.6 percent invested in mutual funds. Ninety percent of the respondents interviewed were not aware of mutual funds or of investing in mutual funds through a Systematic Investment Plan (SIP).
- The Mutual Fund penetration among Indian workforce with household income less than INR 90,000 was 0.1 percent
- Retail investor participation, has been on the rise in Tier 2 and Tier 3 towns in recent times
The AUM mix by investor type clearly show that the major share is with the corporate constituting 49 percent of the total AUM and the retail segment constitutes only 20 percent. The share of Mutual Funds in the Household Financial Saving, comprises of only 8 percent of gross household financial savings in the financial year 2009. Nearly 55 percent invest in Banks, 16 percent in insurance and 11 percent in currency. In the U.K. more than 26 percent in total household saving is in mutual funds. All this points to the immense growth potential in retail segment in India and the need to understand the challenges faced by the retail investor in mutual funds and take necessary steps to increase their engagement which can benefit all stakeholders.

### 3.11 MAJOR CHALLENGES FACED BY THE RETAIL INVESTOR IN INDIA
Recent studies and surveys indicate that the following are some of the major non-driving factors which make the investor hesitant towards investing in mutual funds and serves as a deterrent to potential investors.

- **Low Levels of Customer Awareness:** The major challenge to the mutual fund industry in India in channelizing the household savings into mutual funds is that of the low level of customer awareness and financial literacy. As already stated the IIMS Dataworks data show very low awareness levels among retail investors and this has a direct bearing on the low mutual fund off take in the retail segment.

  Surprisingly, the lack of understanding is the same in metros and tier two cities and majority of them draw little distinction in their approach to investing in mutual funds and direct stock market investment. The rarely understand concepts of risk-return, asset allocation and portfolio diversification concepts. Low awareness of SIPs (System Investment Plan) has resulted in a majority of the customers investing in a lump sum manner.

- **Limited Focus on increasing Retailer Penetration:** The Indian Mutual Fund Industry and only recently stepped up its focus on building the retail AUM in the tier 2 and Tier 3 towns. The primary focus of these players seem to be the institutional investors as they comprise 55 percent of the AUM as of March 2010.

  Large ticket size, tax arbitrage available to corporate on investing in money market mutual funds, easy accessibility to institutional customers concentrated in Tier 1 cities are the factors instrumental in mutual fund houses focusing on the institutional segment.
• **Limited focus beyond Top 20 cities:** The mutual fund industry continues to have limited penetration beyond the top 20 cities. Cities beyond the top twenty only comprise approximately 10 percent of the industry’s AUM as per the industry’s practitioners. The retail population residing in Tier 2 and Tier 3 towns, even if aware and willing, are unable to invest in mutual funds owing to limited access to suitable distribution channels and investor servicing. The distribution network of most mutual fund houses is largely focused on the Top 20 cities given the high cost associated with deeper penetration into Tier 2 and Tier 3 towns.

• **Limited Innovation in Product Offerings:** The Indian Mutual Fund Industry has largely been product – led and not customer focused. There is a proliferation of schemes with a large number of non-differentiated products. They have a limited focus on innovation and product development, thereby catering to the limited needs of the customer. Products that cater to the customer’s life stage needs such as education, marriage and housing are yet to find their way in the Indian Market. The Indian Mutual Fund Industry offers limited investment options viz. capital guarantee products for the Indian Investors, a large majority of whom are risk averse. The Indian market is yet to witness socially responsible investments like green funds, enhanced money market funds, renewable energy funds, climate change funds, etc.,

• **Limited Flexibility in Fees and Pricing Structures:** The fee structure in the mutual fund industry enjoys little flexibility unlike the developed markets where the level of management fees depends on a variety of factors like the investment objective of the fund, fund assets, fund performance and
the nature and number of services the fund offers. While the expenses have continuously risen, the management fee levels have remained stagnant. Distributors are compensated for their services through a fixed charge in the form of entry load and additional fees as considered appropriate by the AMC. Regardless of the quality of advise the service provided, the commission payable by the mutual fund customer, to the distributor is fixed.

- **Limited Customer Engagement:** In the absence of a framework to regulate distributors, both the distributors and the mutual fund houses have exhibited limited interest in continuously engaging with customers post closure of sales as the commissions and incentives have largely been in the form of upfront fees from product sales. As a result of limited engagement, there have been rising instances of mis-selling to customers.

- **Limited Focus of the Public Sector Network on Distribution of mutual Funds:** Public sector banks with a large captive base, significant reach beyond top 20 cities in semi urban and rural areas, and the potential to build retail investor base, have so far played a very limited role in mutual fund distribution. The India Post network, operating the largest postal network in the world, majority of which is in the rural areas, is said to have 250 post offices selling mutual funds of five AMCs only. Further, most of the post offices selling mutual funds are located in Tier 1 and Tier 2 cities which are already catered to by national level and other distributors. Further, the credibility enjoyed by the Nationalized banks, Regional Rural Banks and the cooperative banks in the rural areas have not been fully leveraged to target the retail segment.

- **Multiple Regulatory Frameworks Governing Financial Service Sector Verticals:** The regulatory and compliance requirements vary across
verticals within the financial service sector, especially the mutual funds, insurance and pension funds each of which are governed by independent regulatory framework and are competing for the same share of customer’s wallet. The mutual fund industry lacks a level playing field in comparison within the financial service sector.

- **Mandatory PAN Card Requirement:** The Mandatory PAN card requirement for investing in mutual funds is perceived to restrict significant potential of the mutual fund industry in being able to tap small ticket investors from investing in mutual funds. On the other hand, ULIPS which are deemed to be competing products do not have the mandatory PAN requirement. While the payment for investment into mutual funds can be made only through banking facilities, the purchase of ULIPS can be undertaken through cash.

- **Separate Legal Entity:** The recently introduced NPS regulations requiring the AMCs to create a separate legal entity for the pension fund management has created an additional cost structure for the mutual fund players.

- **Outsourcing Funds:** Outsourcing funds management in excess of INR 80 billion by insurance companies is not permitted and thus restricts an additional revenue opportunity for the mutual fund industry.

### 3.12 KEY DRIVERS FOR INVESTMENT

The confidence and trust the banks enjoy with the investor is one of the reason for investors to go for fixed deposits with the banks. There are various key motivators for the investor to choose mutual funds among other alternatives. This section deals with various drivers for investment and what the investor’s expectations are with respect to the fund houses, regulators, financial advisors etc.
Preferred Channels for Investment

Banks and IFAs are the preferred channel for investing in mutual funds. Customers seem to have more confidence in banks given their long standing relationship and the trust built with banks over the years. To Customers are also accustomed to dealing with Independent Financial Advisors (IFAs) to seek advice on a wide range of investment and financial planning issues. IFAs have demonstrated flexibility in providing customized offering s to the customers at the household level. However it has to be noted that majority of the customers are not satisfied with the quality of advise provided by the IFAs and believe that they do not adopt a holistic approach to financial planning. Also after sale service and ongoing follow up have been identified by customers as a key differentiator in assessing the capabilities of distributors.

3.12.1: Key Growth Drivers and Expected Impact in the Retail Segment

- **Rising Disposable Incomes and Savings** – Increase in disposable incomes and household financial savings may result in households seeking alternate avenues for investments to yield higher returns with reasonable risk.

- **Favourable Demogtraphics** – Favourable demographics like urbanization and a relatively young population having an increased risk appetite, are likely to save more and seek to invest a higher proportion of those savings in market-linked instruments such as mutual funds.

- **Innovations in distribution** – Distribution innovations are expected to increased mutual fund penetration specially in Tier 2 and Tier 3 towns, thereby expanding the mutual fund customer base.
• **Increased Awareness levels** – Improved awareness levels and enhanced financial literacy is expected to aid the understanding of mutual fund products
• **Quality Financial Planning** – Appropriate asset allocation and potential for wealth creation


The Indian Mutual Fund Industry is expected to witness rapid growth in AUM over the next few years. In the event of a quick economic revival and positive reinforcement of growth drivers identified, the KPMG India is of the view that the Indian Mutual Fund Industry may grow at the rate of 22-25 percent in the period from 2010 to 2015, resulting in AUM of INR 16,000 to 18,000 billion in 2015.

**Key growth drivers for this scenario includes**

- **Increased Retail Investor Participation** – Increased Retailer participation with a preference for mutual funds over other asset classes perceived to be more risky. This could result in the fulfillment of growing financial aspirations, enabled by rising disposable incomes and increased financial savings
- **Innovation in Distribution** - innovations in distribution driven by increase in number of certified IFAs and banks selling mutual funds focusing on Tier 2 and Tier 3 towns
- **Increase in Institutional participation** - increase in institutional participation is expected, triggered by rising corporate revenues with increased economic activity.

Market deepening and widening is expected with the objective of increased retail penetration and participation in mutual fund
India being one of the important emerging market destinations, and with the projections showing immense growth potential in future, there is a huge scope for the Indian Mutual Fund Industry for increasing its penetration across the country. If the mutual fund industry wants to increase the retailer participation, it has to work on various dimensions like the customers, markets, products and the regulatory system. With high growth potential on one side and many challenges on the other, it becomes necessary to work on all dimensions discussed above. This study focuses on one important dimension i.e. to understanding investor psychology as this has greater impact on investment decisions. The study thus focuses on the retail segment of mutual fund investors. It is an effort to understand the role of various bias which influences investment decision making.