Chapter 4.

Mutual Funds Industry in India

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Mutual Funds industry in India

4.1. Introduction:

The Indian financial system based on four basic components like financial market, financial institutions, financial service, and financial instruments. All are play important role for smooth activities for the transfer of the funds and allocation of the funds. The main aim of the Indian financial system is that providing the efficiently services to the capital market. The Indian capital market has been increasing tremendously during the second generation reforms. The first generation reforms started in 1991 the concept of LPG. (liberalization, privatization, globalization).

Then after 1997 second generation reforms was started, still the it’s going on, its include reforms of industrial investment, reforms of fiscal policy, reforms of ex-im policy, reforms of public sector, reforms of financial sector, reforms of foreign investment through the institutional investors, reforms banking sectors. The economic development model adopted by India in the post independence has been characterized by mixed economy with the public sector playing a dominating role and the activities in private industrial sector control measures emaciated form time to time. The last two decades have been a phenomenal expansion in the geographical coverage and the financial spread of our financial system.

The spared of the banking system has 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 has been a rapid growth of capital market, money market and financial services industry including merchant banking, leasing and venture capital, leasing, hire purchasing.

Consistent with the growth of financial sector and second generation reforms it’s need to fruition of the financial sector. Its also need to Providing the efficient service to the investor mostly if the investors are supply small amount, in that point of view the mutual fund play vital for better service to the small investors.

The main vision for the analysis for this study is to scrutinize the performance of five star rated mutual funds, given the weight of risk, return, and assets under management, net assets value, book value and price earnings ratio.

4.2. What Is A Mutual Fund?

Mutual fund is the pool of the money, based on the trust who invests the savings of a number of investors who shares a common financial goal, like the capital appreciation and dividend earning. The money thus collect is then invested in capital market instruments such as shares, debenture, and foreign market. Investors invest money and get the units as per the unit value which we called as NAV (net assets value).

Mutual fund is the most suitable investment for the common man as it offers an opportunity to invest in diversified portfolio management, good research team, professionally managed Indian stock as well as the foreign market, the main aim of the fund manager is to taking the scrip that have under value and future will rising, then fund manager sell out the stock. Fund manager concentration on risk – return trade off, where minimize the risk and maximize the return through diversification of the portfolio. The most common features of the mutual fund unit are low cost. The below i mention the how the transactions will done or working with mutual fund.

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4.3. Concept of mutual funds:

TABLE 4.1 CONCEPT OF MUTUAL FUNDS

4.4. Emergence of the Mutual Fund Industry in India

The origin of the Indian mutual fund industry can be traced back to 1964 when the Indian government, with a view to augment small savings within the country and to channelize these savings to the capital markets, set up the unit trust of India (“UTI”). The UTI was setup under a specific statute, the unit trust of India act, 1963. The unit trust of India launched its first open-ended equity scheme called unit 64 in the year 1964, which turned out to be one of the most popular mutual fund schemes in the country. In 1987, the government permitted other public sector banks and insurance companies to promote mutual fund schemes. Pursuant to this relaxation, six public sector banks and two insurance companies viz. Life insurance corporation of India and general insurance corporation of India launched mutual fund schemes in the country. Subsequently, in 1993, the securities and exchange board of India ("SEBI") introduced the securities and exchange board of India (mutual funds) regulations, 1993, which paved way for the entry of private sector players in the mutual fund industry.
In the period between 1963 and 1988, when the UTI was the sole player in the industry, the assets under management grew to about Rs. 67 billion\(^1\). In the second phase between 1988-1994, when public sector banks and insurance companies were allowed to launch mutual fund schemes, the total assets in the mutual fund industry grew to about Rs. 610 billion with the total number of schemes increasing to 167 by the end of 1994.

The third phase of the mutual fund industry, which commenced in 1994, witnessed exponential growth of the industry, with the advent of private players therein. Kothari pioneer mutual fund was the first fund to be established by the private sector in association with a foreign fund. As on September 30, 2002, the total assets under management stood at Rs. 1069 billion and the total number of schemes stood at 384.

During the last three and a half decades, UTI has been a dominant player in the mutual fund industry. The total assets under the management of the UTI as on September 30, 2002 were to the tune of Rs. 442 billion, which amount to almost 41% of the total assets under management in the domestic mutual fund industry. UTI has witnessed some erosion of assets pursuant to the last years crisis arising on account of its unit 64 scheme, the scheme with largest amount of assets under management. This was the first scheme launched by the UTI with a significant equity exposure and the returns of which was not linked to the market.

This resulted in a payment crisis when the stock markets crashed during the last two years which resulted in some degree of loss of investors’ confidence in UTI leading to erosion of its assets under management. This period also gave opportunity to the private players to demonstrate better returns thereby capturing a significant market share. As at the end of September 30 2002, there are in all 22 private sector funds (excluding UTI and funds sponsored by banks and other government institutions) operating in India with total assets 1 rupees one billion = approx USD 20.9 million as of date. Under management of Rs. 529 billion.
4.5 Structure of a Mutual Fund:

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

The custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI regulations by the mutual fund.

A typical mutual fund structure in India can be graphically represented as follows:

![Figure 4.2: Structure of a Mutual Fund](image-url)
4.6. **Origin of Mutual Fund in India** -:

The history of mutual funds dates back to 19th century when it was introduced in Europe, in particular, great Britain. Robert Fleming set up in 1968 the first investment trust called foreign and colonial investment trust which promised to manage the finances of the moneyed classes of Scotland by spreading the investment over a number of different stocks. This investment trust and other investments trusts which were subsequently set up in Britain and the us, resembled today’s close – ended mutual funds. The first mutual in the U.S., Massa Chust Settes investor’s trust, was set up in March 1924. This was the open – ended mutual fund.

The stock market crash in 1929, the great depression, and the outbreak of the second world war slackened the pace of mutual fund industry, innovations in products and services increased the popularity of mutual funds in the 1990s and 1960s. The first international stock mutual fund was introduced in the U.S. In 1940. In 1976, the first tax – exempt municipal bond funds emerged and in 1979, the first money market mutual funds were created. The latest additions are the international bond fund in 1986 and arm funds in 1990. This industry witnessed substantial growth in the eighties and nineties when there was a significant increase in the number of mutual funds, schemes, assets, and shareholders. In us, the mutual fund industry registered a ten – fold growth the eighties. Since 1996, mutual fund assets have exceeded bank deposits. The mutual fund industry and the banking industry virtually rival each other in size.

4.7. **Growth of Mutual Funds in India**

By the year 1970, the industry had 361 funds with combined total assets of 47.6 billion dollars in 10.7 million shareholder’s account. However, from 1970 and onwards rising interest rates, stock market stagnation, inflation and investors some other reservations about the profitability of mutual funds, adversely affected the growth of mutual funds. Hence mutual funds realized the need to introduce new types of mutual funds, which were in tune with changing requirements and interests of the investors. The 1970’s saw a new kind of fund innovation;
funds with no sales commissions called “no load “funds. The largest and most successful no load family of funds is the vanguard funds, created by John Bogle in 1977.

In the series of new product, the first money market mutual fund (MMMF) i.e. The reserve fund” was started in November 1971. This new concept signaled a dramatic change in mutual fund industry. Most importantly, it attracted new small and individual investors to mutual fund concept and sparked a surge of creativity in the industry.

4.8. Current Industry Assessment –

The Indian mutual fund industry has shown relatively slow growth in the period FY 10-13 growing at a CAGR of approximately 3.2 per cent. Average (AUM) stood at inr 8,140 billion as of September 2013. However, AUM increased to INR 8,800 billion as of December 2013.

Growth of the AUM:

Source: The Association of Mutual Funds in India (AMFI); Data as of September 2013
Note: Figures from FY11 - FY13 corresponds to average AUM for the quarter Jan - Mar (Q4)

CHART 4.3 Growth of the AUM
Lackluster stock market performance, rising inflation and anticipation of a rise in interest rates has led to a tapering of growth in the Indian mutual fund industry in the recent years. In comparison to global markets, India’s AUM penetration as a per cent of GDP is between 5-6 per cent while it is around 77 per cent for the U.S., 40 per cent for Brazil and 31 per cent for South Africa.

**Growth in Markets -**

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**Source:** BSE Sensex and NSE Nifty data as on December 2013

**CHART 4.4 Growth in Markets**

Despite the relatively low penetration of mutual funds in India, the market is highly concentrated. Though, there are 44 AMCs operating in the sector, approximately 80 per cent of the AUM is concentrated with 8 of the leading players in the market. There have been recent instances of consolidation in the market and market concentration is expected to remain in the near-term.

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3. The Association of Mutual Funds in India (AMFI)
4. ICI Fact book 2012, World Bank data, AMFI
Market Share of leading Mutual Funds (basis AUM)

Source: The Association of Mutual Funds in India (AMFI); Data as of September 2013

CHART 4.5 - Market Share of leading Mutual Funds

4.8.1. Products and Investors

Indian stock markets have experienced inconsistent returns in the recent past. Higher inflation and inconsistent economic growth has worried the retail investor who is now concerned about assured returns. In such a scenario, the investor would divert their funds from the equity market to liquid/money market and debt AUM as also depicted in figure.
The equity-debt mix is determined largely by the performance of the capital markets and interest rate cycles. AUMs in debt and liquid money market funds have seen an increase in fy14 due to the anticipation of RBI rate cuts and desire for investors to seek a fixed return. Debt oriented products (investing in debt instruments with maturity > 3 months) have gained most traction in terms of absolute net new money, with an absolute increase in AUM of ~INR 1,000 billion indicating a clear shift in investor interest from equity in recent times.

Gold ETF’s have grown at an extremely fast pace over the last few years albeit from a much smaller base (CAGR of over 90 per cent from fy10- fy13). these have gained popularity due to the popularity of gold as an investment for Indians as well as due to the lowering of

Source: The Association of Mutual Funds in India (AMFI); Data as of September 2013
These have gained popularity due to the popularity of gold as an investment for Indians as well as due to the lowering of administrative charges and distribution expenses which makes it easier for the product to be distributed as well.

As figure indicates, industry composition of AUM is driven primarily by the corporate segment.

**Fig. : AUM Composition by Investor Segment**

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**Source:** The Association of Mutual Funds in India (AMFI); Data as of September 2013

**CHART 4.7 - : AUM Composition by Investor Segment**

Corporate investments constitute around 49 per cent of AUM with a focus on debt/money market funds for the purpose of short term returns and liquidity management. Retail share of AUM is 20 per cent and is expected to rise driven by increased investor awareness, product penetration and greater distribution reach.

High net worth individual (HNIs) have emerged as the fastest growing investor segment growing at a rate of ~ 20 per cent over the period of fy10- fy13 with a preference for debt oriented funds.
However, AUM growth largely remains restricted to the top 5 cities in India viz. Mumbai, Delhi, Bangalore, Chennai and Kolkata (contributing ~ 74 per cent of AUM as of September 2013). The top 35 cities continue to contribute around 90-92 per cent of the industry AUM.

However, despite the potential offered by the mutual fund industry, there still remain some key challenges faced by the industry which have had an impact on growth.

### 4.8.2. These Include:-

- limited incentives for distributors for mf products as compared to other financial products
- lack of product differentiation and ability to communicate value to investors
- low mf penetration and relatively lower addition of retail investors
- lack of investor awareness about mf industry
- evolving nature of industry regulations

The key to combating these challenges is to ensure a wider distribution reach to widen the existing base of the industry. Additionally, there needs to be an improvement in overall investor awareness through strategic initiatives and investor education drives to drive growth.

The next section elaborates key trends that may have an impact on the future growth of the industry.

### 4.9. Future Potential of the Indian MF Industry:-

While the long-term outlook for the asset management industry in India seems to be positive, our stance on short to medium term outlook is moderate. This can be attributed to the existing performance in financial markets and the evolving market and regulatory landscape.

6. Www.nseindia.com
7. Month end AUM – Classification by product
AUM composition of investor classes ->
Equity AUM composition by investor classes

Source: The Association of Mutual Funds in India (AMFI); Data as of September 2013;
Note: Figures in INR billion as on 31st March Financial Year

CHART 4.8 Equity AUM composition by investor classes

NON EQUITY AUM COMPOSITION BY INVESTORS CLASSES-

Source: The Association of Mutual Funds in India (AMFI); Data as of September 2013
Note: Figures in INR billion as on 31st March Financial Year.

CHART -4.9 NON EQUITY AUM COMPOSITION BY INVESTORS CLASSES-
Equity markets haven’t performed since the global financial crisis. The broad equity stock index NSE has grown only by 2 per cent y-o-y and was below the 3 year mark as of Sept 2013. This was well reflected in the equity AUM growth, which has undergone a negative growth in AUM base at 10 per cent and 20 per cent over the same time period.

The investors have redeemed their investments and moved to products with stable yields. The performance of equity markets will continue to reflect in the equity AUM till the equity markets stabilize.

HNIs have emerged as the fastest growing investor class in the debt oriented products. In particular, fixed maturity plan (FMPs) continue to remain a popular product and have consistently given better performance and tax advantage over bank FDs. Debt oriented products are slowly gaining recognition among the retail8 investors. Retail investments increased from INR 228.3 billion in Sept 2010 to INR 331.6 billion in Sept 20139. But they still have a long way to go and capture the small ticket market.

As the asset management industry grows and moves towards a mature stage, the manufacturers and distributors have to constantly adapt to a changing market environment and abide to new regulations that come along the way of development.

Manufacturers are continually developing a broad range of products covering new asset classes (gold) and investment strategies (fund of fund, arbitrage, duration etc. Among others). But this product innovation has been a mixed bag to garner new AUM.

The level of financial literacy amongst the Indian investors is still low and is the impending factor in new and innovative products becoming successful in the Indian market. Sophisticated products still remain a very small proportion of the industry AUM as shown in the product-wise AUM chart above.

Some of the challenges which lead us to have a moderate view on the growth prospects of the Indian mutual fund industry are described in detail below.
### Category-wise Mutual fund performance:

<table>
<thead>
<tr>
<th>Category average return</th>
<th>1 Year</th>
<th>2 Years</th>
<th>3 Years</th>
</tr>
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<tr>
<td><strong>Equity And Hybrid Equity</strong></td>
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<td></td>
<td></td>
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<td>Large Cap Equity Fund</td>
<td>2.9</td>
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<td>1.9</td>
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<td>Diversified Equity Fund</td>
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<td>5.3</td>
<td>2.8</td>
</tr>
<tr>
<td>International/Global Commodities</td>
<td>8.6</td>
<td>5</td>
<td>1.4</td>
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<td><strong>Benchmarks Indices</strong></td>
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<td>CNX Nifty</td>
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<td>24.9</td>
<td>10.4</td>
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<td>S&amp;P Sensex</td>
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<td>26.7</td>
<td>11.3</td>
</tr>
<tr>
<td>S&amp;P Small cap</td>
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<td>4</td>
<td>-26.7</td>
</tr>
<tr>
<td>S&amp;P Midcap</td>
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<td>15.4</td>
<td>-8.7</td>
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<tr>
<td><strong>Debt And Hybrid Debt</strong></td>
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<tr>
<td>Long Term Income Funds</td>
<td>4.8</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Short Term Income Funds</td>
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<td>5.2</td>
<td>4.9</td>
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<td>Liquid Funds</td>
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<td>Ultra Short Funds</td>
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<td>Gilt Short term funds</td>
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<td>2.9</td>
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<tr>
<td>Gilt Long term funds</td>
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<td>3.4</td>
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</tr>
<tr>
<td>Balanced</td>
<td>4.4</td>
<td>5.9</td>
<td>2.8</td>
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</tbody>
</table>

As on 20 Jan 2014

Source: Money control; Returns over 1 year are annualized.

**TABLE 4.10-**: Category-wise Mutual fund performance
Distribution of mutual fund products is one of the critical components in the entire value chain of the asset management industry. More so, where investment is highly underpenetrated. For example, the north eastern region holds tremendous potential on account of its very low penetration and awareness about investments.

The region has 2.5 per cent of total bank branches which accounts for 1.3 per cent of banking business but only 0.3 per cent of aum9. People save their money in banks rather than investing it in the market. The investment advisors could help in serving this underserved region by making them aware of the financial products.

Scale is important in an asset management landscape in India. Once an asset manager gains sufficient scale, it has the capital strength to fund its growth or in other words, it has the financial capacity to pay upfront and trail commissions to the distributors and expand reach. Small and mid-sized mutual funds have found it consistently difficult to increase their reach since the regulatory structural change in 2009. This coupled with tepid stock markets has not been very favorable for smaller mutual funds.

Therefore the smaller players continue to struggle to gain market share and remain profitable at the same time. This has resulted in some smaller players exiting the industry in the recent past.

4.10. Key Upcoming Trends in the Indian Mutual Fund Industry —:

In order for the mutual fund industry to look at new avenues and areas for growth in India has analyzed a few areas which may impact growth in a positive manner.

4.10.1. Expansion Outside Beyond -15 Cities-:

Despite constant endeavor of the regulator to increase penetration of mutual fund products beyond top 15 cities, the AUM composition has only marginally changed since SEBI directive on additional TER on inflows from smaller cities was implemented in October 1st, 2012. Contribution from the b-15 cities has remained at around 13 per cent for the last two years. Drivers like lack of financial education and awareness, limited distribution network, cultural bias
towards physical assets are some of the key impediments to growth in b-15 cities.

4.10.2. AUM Composition by Geography:

Industry AUM composition by Geography:

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10. Additional TER can be charged up to 30 basis points on daily net assets of the scheme if the new inflows from beyond top 15 cities are at least (a) 30per cent of gross new inflows in the scheme or (b) 15per cent of the average assets under management (year to date) of the scheme, whichever is higher.
AUM from B-15 for Top 5 amcs –

Chart 4.12: Industry AUM composition by Geography:

The industry has adopted multi-pronged approach to reach out to investors in b-15 cities which includes investor awareness, training and enrolling new cadre of distributors. In addition, fund houses are paying additional commission to source applications from these areas.

4.10.3. Key Challenges:

• Lack of Financial Education and Awareness:
  Financial literacy is one of the most fundamental factors impeding the growth of penetration of any financial products in the smaller cities and towns. Investors need to be made aware of their financial goals and the means to achieve the same.
  AMFI and SEBI along with the industry are making efforts for investor awareness campaign. Fund houses are also mandated by regulation to invest 2 bps from scheme expenses towards, investor education and awareness campaigns but India has a long way to go.

• Limited Distribution network:
  The second critical issue for fund houses to distribute their products in smaller cities is the availability of quality distribution Infrastructure.

8. Categorized As Ticket Size > INR 5 Lakhs
Fund houses need infrastructure like branches, adequate number of relationship managers and sales service staff in these locations to be able to increase their sales volume coming from these geographies.

**Distribution cost**

Cost of establishing a distribution network in b-15 cities is quite high. It is the cost per transaction or the low sales volume that makes the pursuit economically unviable or at the least challenging. Although, additional TER can be levied to extend of inflows from these cities (up to 30 bps); entering these markets have a long gestation period and requires a capital investment for distributors.

**Cultural Bias towards Physical Assets**

As of fy13, 46 per cent of total individual wealth in India is invested in physical assets (gold and real estate) 11. Although, in the past few decades, the investors have increasingly relied on financial assets to invest their savings; the contribution of MFS in the asset portfolio is very low. Insurance products constitute 17 per cent of the individual savings in financial assets, whereas the share of mutual funds is much lower at 3.2 per cent12

### 4.10.4. Key Imperatives for Expansion in B-15 Cities -:

Unique problems call for innovative solutions. The distribution landscape, the cost dynamics, underlying cultural imprint and investor behavior in the smaller cities is much different than metros. Therefore, the fund houses could look at some innovative sales strategies for these geographies.

**A Trusted Sales Agent**

Even today, in India, the financial investments are mostly driven by trust and relationship. In such cases, investors would prefer to buy from a known face rather than an unknown one. Independent financial adviser (IFAs) serves as an important link between the sellers and buyers of the financial products. They have a good hold and influence over their clients and their purchasing decisions. Therefore, it is important to tap the IFAs that have a client base in b-15 cities.

To increase the base of mutual fund distributors, the regulator has permitted a new cadre of distributors which includes postal agents,
retired government and semi government officials, retired teachers, retired bank officers and other persons (such as bank correspondents) to sell units of simple and performing mutual fund schemes.

- **Partnering With a Bank**

  Fund houses could leverage from large network of bank branches covering the hinterland as well. Bank sponsored AMCs such as HDFC, MF, SBI MF have a greater advantage over the other asset management players.

  Fund houses could leverage from a bank’s network in multiple ways—the bank branches, employees, ATM network, banking correspondents’—could be used as point of sales at various levels. Partnering or forming a strategic alliance with a public sector bank with vast presence in non metro areas would help fund houses in amassing assets from b-15 cities.

- **Technology**

  Technology can be the game changer in the near future. As the cost of establishing a distribution network in b-15 cities is comparatively high, technology could play a pivotal role in garnering new AUM via internet and mobile banking channels.

  Online channel for mutual funds is increasingly becoming popular amongst investors. Almost all, fund houses in India provide service to transact online. There are 143 million internet users3 in India, out of these, 24 million access internet through their mobiles. Mobile banking has been very successful in countries like Zimbabwe and Kenya.

  India has over 904 million telecom subscribers13 (97 per cent are wireless subscribers) as of 31 October 2013. 40 per cent of these subscribers live in rural areas and can be tapped through mobile phones. Using mobile phones to purchase mutual funds could have a potential to increase investments in b-15 cities. Many mutual funds have already enabled purchase of mutual fund units through immediate payment services (IMPs) and more Recent national automated clearing house system (NACH) platform, which have made the buying mutual funds for investors’ paper less.

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9. The Association Of Mutual Funds In India (AMFI)
The transactions can be done either via SMS or via an application. The technology is further developing to make it more user friendly and hassle free. For example, now investors can invest in sips of various schemes at once.

A new investor needs to fill up the common application form, along with ‘know-your-investor’ documents and a registration form. After the folio is created and the investor receives personal identification number (PIN), he can download the mobile application to buy and sell fund units. The existing investors can also avail of this facility. The third tool in the hand of fund houses is enabling their sales channels with technology. Services like portfolio management and data analytics can be easily performed on the go using smart phones or tablets.

4.10.5. Emergence of Alternate Channels:

Over the last few years, Indian mutual fund industry has grown at a rapid pace until global financial crisis of 2008. The various distribution channels that have evolved over the years for the asset management companies (AMCs) include:

- National and Regional Distributors
- Banks
- Independent Financial Advisors
- Direct Selling

Further, apart from these channels, AMCs are also leveraging the extensive reach of the India post, which has a large investor, base and branches spread across India. However, the potential is not fully utilized yet. The post offices’ remarkable presence in both urban and rural India has substantial sales potential and could emerge as an effective sales channel in the future. National and regional distributors historically have constituted this traditional channel for selling mutual funds. While banks and the national distributors target mostly wealthy and corporate clients, the regional distributors, IFAs and India post primarily target regular retail investors. Direct and IFA channels could

11. India wealth report, 2013
12. India online landscape, 2013
remain key to unlocking growth in terms of sourcing equity inflows from outside the b-15 cities.

4.10.6. **Key Challenges:**

Despite the presence of various alternative channels in the industry, the distribution network still lacks proper strength and faces many challenges. All the channels have a common concern of lack of adequate investor education and financial literacy among investors.

- **Discouraging Norms for ifas**

  IFAS have the potential to widen the distribution network and expand the reach on a sustainable basis. As indicated in the chart above, IFAS have comparatively performed well beyond the top 15 cities. However, not much has been done to strengthen this channel. In fact, the new slew of norms and regulations have put pressure on further evolution of this channel Eg. Abolishing of entry loads etc.

  One of the major threats to IFAs arises out of direct plan option for investors. With SEBI incentivizing the direct plans in 2012, it would be detrimental to the business of the IFA if investors shift their focus to direct plans. To retain clients and prevent them from opting for direct plans, the quality of advice and service has to be improved. Their approach needs to be more service oriented rather than transaction oriented.

- **Channel – Product Alignment**

  Distribution channels fail to market the mf products properly. They need to customize the product delivery system, and make it investor-oriented. Introducing a scheme in a semi-urban or a rural zone depends on the needs of the investors and IFAs are better than the rest of the channels in understanding the varied needs of the investors.

- **Technology for simplification of processes**

  To increase the footprint through technological advancements, product and process simplification is required. Key is to simplify rather than innovate. Also, internet penetration is low in India as compared to other countries. India’s internet penetration is only 17 per cent (6.7 %

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14. Telecom Regulatory Authority of India (TRAI)
rural India) compared to 81 per cent in the U.S. And 42.3 per cent in China. Mobile internet penetration stood at merely 2.4 per cent. Furthermore, issues like transaction failure and rejections for online transactions will continue to remain key deterrents.

4.10.7. Emergence of Investment Advisors

In the recent few years from abolishing entry loads on mutual funds to a host of other measures, SEBI has been looking at increasing regulation with a view to improve the investment climate recently, SEBI has announced a new series of regulations governing investment advisors15. The regulation was made with the intent of ensuring the regulation of individuals, firms and corporations providing investment advice to investors.

This move was aimed at drawing a distinction between agents and advisers who provide financial advice to the investor for a fee but will not seek a commission from the AMC for directing investors toward investing in a particular scheme/plan. This regulation was also undertaken to ensure that the advisory functions of investment companies will not be motivated by the desire to earn distributor commissions or commissions from product manufacturers leading to a potential conflict of interest.

While the regulation was intended to have a positive effect, there has been limited movement in terms of individuals/firms looking to register as investment advisers. SEBI has indicated that it has received over 70 applications, but currently only 11 investment advisers have received licenses.

Most of the advisers who have received licenses have a good reputation in the market as wealth advisers and financial planners indicating their seriousness and willingness to receive a fee from investors for their advisory services. Most of the AMCs have adopted a ‘wait and watch’ strategy before choosing to engage with this particular channel.

We believe that the onset of this regulation brings with it certain key advantages to the Indian investor who is looking to invest in mutual funds in terms of greater trust and access to advice from

certified financial planners for the mass affluent/medium net worth individuals segment (MNI).

4.10.8. **Key Challenges:**

- **Investor Mentality**

  India is still a relatively under penetrated market when it comes to paying for financial advice. Most investors are not comfortable paying a fee when it comes to receiving financial advice and even more so in years where the market sees greater volatility and when there may be potential losses on investments. In the past, HNIs who have the knowledge and wherewithal to appoint someone to manage their finances have paid for advice. However, in the mass affluent segment, paying for advice still remains a relatively nascent concept.

- **Lack of Investor Awareness**

  As opposed to developed markets, financial awareness and literacy of the average Indian investor is relatively low. Given the propensity of the Indian investor to prefer savings in physical form like real estate, housing and gold, investments in mf instruments are relatively low compared to these other instruments. Mf instruments constituted ~3% of Indian financial assets as opposed to gold and real estate which contributed ~46% of financial assets. Increasing awareness to promote mf investment will remain a key challenge.

- **Blurred Lines between the Adviser and Distributor**

  While SEBI has tried to draw a line between advisers and distributors, there may still be some potential grey REAs. Advisers can still earn commissions and their investors may not be aware of the same. Furthermore, distributors also provide informal advice to investors, while still receiving commissions from product manufacturers which are not in line with the regulations by SEBI.

15. SEBI Investment Advisers Regulations 2013
16. Livemint Article, October 21 2013
4.10.9. **Key Imperatives for Investment Advisers:**

While the complete impact of these regulations is yet to be felt, additional clarity from SEBI should lead to registration and empanelment of more certified financial planners. The regulations can largely help ensure that financial advisers who will be charging a fee for their services will look at recommending direct schemes/plans of the AMCs which have demonstrated a consistent track record of fund performance and have strong brand equity in the market. Given that they would look at investor retention and the increasing share of the wallet, investment advisers may not be incentivized to favor any particular product and may look at the interest of the investor.

However, there can be instances of regulatory arbitrage where a financial adviser can get a fee from an investor but use a related party to make the investment on behalf of the investor and still end up getting a commission from the AMC.

Given that there are approximately 44 AMCs operating in the market offering a wide range of products across equity, debt and hybrid schemes; it offers a multitude of options to the Indian investor looking to invest in mutual funds. Navigating through these options require substantial time and investment from an investor which could be made easier through a financial planner. Investment advisers could gain relevance as a sounding board and help investors navigate through complexity. However, the concept would win approval from the investors only when they see value in terms of returns and advice from the financial planner/ adviser. This channel can emerge as a relevant model in the medium-term when the industry moves towards an advisory led model.

4.11. **Regulations:-**

In mid 2012, SEBI took note of the fact there is a lack of penetration of mutual fund products, inadequate distribution network, regulation of distributors, investor protection, etc to address these issues, SEBI announced slew of measures to develop a long term policy including financial inclusion to achieve sustainable growth of the mutual fund industry.
While the measures are positive steps to increase the foot print of the mutual fund industry, certain other emerging issues may need to be addressed separately.

4.11.1. Feet-On-Street Distribution-
Postal agents, retired officials of government, retired teachers, retired bank officers etc. Who have been in service for at least 10 years were allowed to sell simple products so as to increase the distribution base for mutual fund?

To take this initiative further, AMFI decided to include intermediaries/agents engaged in distribution of financial products e.g. insurance agent, FD agent, national savings scheme products, PPF, etc. Registered with any other financial services regulator within the ambit of mutual fund distributors.

To incentivize this new force to undertake mutual fund selling, AMFI has waived off registration fees for all first time registrations and new cadre of distributors subject to fulfillment of prescribed conditions. While the measure could boost the foot print of AMC, there is increasing need to be cautious of the risk of Mis-selling due to lack of knowledge on the investors part.

4.11.2. Fungibility of TER
In an attempt to increase mutual fund foot print, AMCs are allowed to charge an additional ter19 up to 30 bps, if 30 per cent of their net sales or 15 per cent of their AUM (whichever is higher) originates from places beyond top 15 cities b-15.

If inflow from b-15 is less than 30 per cent of net sales or 15 per cent of AUM, the proportionate amount will be allowed as additional TER.

While this step has the effect of reducing the investors returns in short term, it may give AMCs more scope to incentivize distributors to expand their geographical reach.

17. INDIA WEALTH REPORT 2013
18. AMFI
4.11.3. **Penetration**

SEBI has also permitted small investors (who may not be tax payers and also do not have pan/bank account) such as farmers, small traders/businessmen/workers to make a cash investment up to Rs. 20,000 in mutual fund schemes.

While there is no requirement for the investors to have a pan/ bank account, it is unclear how the redemption proceeds would be paid to such investors since it is mandated that any repayment should be credited to the bank account of the investors.

The distributor could find this mode of investment unattractive as handling of cash requires higher safeguards. As also, cash investments could also give rise to opportunity for money laundering, frauds and meddling by tax officials. Considering the cost involved in handling cash investments coupled with other complexities, this measure may have several difficulties in implementation.

4.11.4. **Self Regulatory Organization (SRO)**

Presently, distributors have to obtain certification from national institute of securities market (NISM) and registration with AMFI. Apart from the code of conduct prescribed by SEBI and AMFI, there are no such regulations governing distributors.

In order to avoid Mis-selling and to protect investors interest, SEBI plans to appoint a SRO which would regulate the distributors of mutual fund products, portfolio management products etc.

SRO will form rules and regulations for distributors, hear investor complaints against distributors among many others. The SRO should aid SEBI to ensure a cordial relationship between mutual fund houses and distributors and broaden the MF industry.

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19. Expense Ratio is the fee charged by a fund house to manage and operate the fund. The charges include management fees, administrative fees, and other operating costs. Lower the tar, higher the returns for investors and vice versa.
4.11.5. **Overseas Distributor** -

In order to encourage the growth prospects of the Indian mutual fund industry in the international market, SEBI recently prescribed that overseas distributor would neither be required to obtain certification from NISM nor would require AMFI registration.

The sole requirement is to comply with the extant laws, rules and regulations applicable in their jurisdictions. Despite SEBI guidelines, the AMFI registration number committee has suggested that overseas distributors may register with AMFI for tracking and Mis purpose.

The AMC’s are bestowed with the responsibility to carry out due diligence of overseas distributor. This measure will remove entry barriers and bolster NRI investment in Indian mutual fund.

4.11.6. **Members of Stock Exchange**-

Recently, SEBI permitted mutual fund distributors and independent financial advisor (IFA) registered with AMFI to become members of stock exchanges to leverage the stock exchange network and infrastructure so that they can augment their reach and distribution.

Distributors and IFA can purchase and redeem mutual fund units on behalf of client from fund houses using the stock exchanges trading platform.

Till date, SEBI registered stock-brokers and clearing members were allowed to transact in mutual fund’s leaving the distributor/IFA behind in race. Considering the fact that major chunk of mutual fund’s are sold through this medium, the change will give an impetus to the distributor.

With this new circular, the investor can inform his/her distributor/IFA to purchase units on stock exchange and the payment for the same will be made directly by investors to the recognized clearing corporation. However, the additional financial and compliance burden may create a deterrent for the distributor from seeking membership.
4.12. *Classification of Mutual Funds and Schemes*

Types of Mutual Funds -

*Figure 4.12*: Types of Mutual Funds
1. **Schemes According To Maturity Period**: A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period.

   - **Open-Ended Fund/ Scheme**: An open-ended fund or scheme is one that is available for subscription and repurchase on a continuous basis. These schemes do not have a fixed maturity period. Investors can conveniently buy and sell units at net asset value (NAV) related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.

   - **Close-Ended Fund/ Scheme**: A close-ended fund or scheme has a stipulated maturity period e.g. 5-7 years. The fund is open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of the initial public issue and thereafter they can buy or sell the units of the scheme on the stock exchanges where the units are listed. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices. SEBI regulations stipulate that at least one of the two exit routes is provided to the investor i.e. either repurchase facility or through listing on stock exchanges. These mutual funds schemes disclose NAV generally on weekly basis.

2. **Schemes according to Investment Objective**: A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified 20 mainly as follows:

   - **Growth / Equity Oriented Scheme**: The aim of growth funds is to provide capital appreciation over the medium to long-term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide different options to the investors like dividend option, capital appreciation, etc. And the investors may choose an option depending on their preferences. The investors must indicate the option in the application
form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time.

- **Income / Debt Oriented Scheme** - The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities such as bonds, corporate debentures, government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations.

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

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

- **Gilt Fund** - These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.
- **Index Funds:** Index funds replicate the portfolio of a particular index such as the BSE sensitive index, S&P NSE 50 index (NIFTY), etc. These schemes invest in the securities in the same weightage comprising of an index. NAVs of such schemes would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factors known as "tracking error" in technical terms. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme.

3. **Sector Specific Funds/Schemes:** These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. E.g. Pharmaceuticals, software, fast moving consumer goods (FMCG), petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time. They may also seek advice of an expert.

4. **Tax Saving Schemes:** These schemes offer tax rebates to the investors under specific provisions of the income tax act, 1961 as the government offers tax incentives for investment in specified avenues. E.g. equity linked savings schemes (ELSS). Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest predominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

5. **Fund of Funds (fof) scheme:** A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a FOF scheme. An FOF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

6. **Load Or No-Load Fund:** A load fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the

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21. Mutual Funds In India Emerging Issues By Nalini Prava Tripathy P.54
fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase to the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the performance track record and service standards of the mutual fund which are more important. Efficient funds may give higher returns in spite of loads. A no-load fund is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and no additional charges are payable on purchase or sale of units.

4.13. Mutual Fund Investment Strategies

- **Systematic Investment Plan (Sips):** These are best suited for young people who have started their careers and need to build their wealth. Sips entail an investor to invest a fixed sum of money at regular intervals in mutual fund scheme the investor has chosen. For instance an investor opting for sip in xyz mutual fund scheme will need to invest a certain sum of money every month / quarter /half year in the scheme.

- **Systematic Withdrawal Plan (swps):** These plans are best suited for people nearing retirement. In these plans an investor invests in a mutual fund scheme and is allowed to withdraw a fixed sum of money at regular intervals to take care of expenses.

- **Systematic Transfer Plan (stps):** They allow the investors to transfer on a periodic basis a specified amount from one scheme to another with in the same fund family meaning two schemes belonging to the same mutual fund. A transfer will be treated as redemption of units from the scheme from which the transfer is made. such redemption or investment will beat the applicable nav. This service allows the investor to manage his investment actively to achieve his objectives. Many funds do not even charge even any transaction feed for this service an added advantage for the active investor.
4.14. Risk Management and SWOT Analysis in Mutual Fund -

4.14.1. Parameters of Mutual Fund Performance Evaluation:

1. Risk
2. Returns
3. Liquidity
4. Expense Ratio
5. Composition Of Portfolio

1. Risks Associated With Mutual Funds

Investing in mutual funds as with any security, does not come without risk. One of the most basic economic principles is that risk and reward are directly correlated. In other words, the greater the potential risk, the greater the potential return. The types of risk commonly associated with mutual funds are:-

- **Market Risk:** Market risk relate to the market value of a security in the future. Market prices fluctuate and are susceptible to economic and financial trends, supply and demand, and many other factors that cannot be precisely predicted or controlled.

- **Political Risk:** changes in the tax laws, trade regulations, administered prices etc. Is some of the many political factors that create market risk? Although collectively, as citizens, we have indirect control through the power of our vote, individually as investors, we have virtually no control.

- **Inflation Risk:** inflation or purchasing power risk, relates to the uncertainty of the future purchasing power of the invested rupees. The risk is the increase in cost of the goods and services, as measured by the consumer price index.

- **Interest Rate Risk:** interest rate risk relates to the future changes in interest rates. For instance, if an investor invests in a long term debt mutual fund scheme and interest rate increase, the NAV of the scheme will fall because the scheme will be end up holding debt offering lowest interest rates

- **Business Risk:** business risk is the uncertainty concerning the future existence, stability and profitability of the issuer of the security. Business risk is inherent in all business ventures. The future financial
stability of a company can not be predicted or guaranteed, nor can the price of its securities. Adverse changes in business circumstances will reduce the market price of the company’s equity resulting in proportionate fall in the NAV of mutual fund scheme, which has invested in the equity of such a company.

➢ Economic Risk: economic risk involves uncertainty in the economy, which, in turn can have an adverse effect on a company’s business. For instance, if monsoons fall in a year, equity stocks of agriculture bases companies will fall and NAVs of mutual funds, which have invested in such stocks, will fall proportionately. There are 3 different methods with the help of which we can measure the risk


I. Beta Coefficient Measure of Risk

Beta relates a fund’s return with a market index. It basically measures the sensitivity of funds return to changes in market index.

If Beta = 1
Fund moves with the market i.e. Passive fund
If Beta < 1
Fund is less volatile than the market i.e. defensive fund
If Beta > 1
Funds will give higher returns when market rises & higher losses when market falls i.e. Aggressive fund.

II. Ex–Marks or R-squared Measure of Risk:

Ex–marks represents co relation with markets. Higher the ex–marks lower the risk of the fund because a fund with higher ex–marks is better diversified than a fund with lower ex–marks.

III. Standard Deviation Measure of Risk:

It is a statistical concept, which measures volatility. It measures the fluctuations of fund’s returns around a mean level. Basically it gives you an idea of how volatile your earnings are. It is broader concept than beta. It also helps in measuring total risk and not just the market risk of the portfolio.

4.14.3. **How to Calculate the Value of a Mutual Fund:**

The investors’ funds are deployed in a portfolio of securities by the fund manager. The value of these investments keeps changing as the market price of the securities change. Since investors are free to enter and exit the fund at any time, it is essential that the market value of their investments is used to determine the price at which such entry and exit will take place. The net assets represent the market value of assets, which belong to the investors, on a given date. Net asset value or NAV of a mutual fund is the value of one unit of investment in the fund, in net asset terms.

\[
NAV = \frac{\text{Net Assets of the Scheme}}{\text{Number of Units Outstanding}}
\]

Where net assets are calculated as:

\[-(\text{market value of investments + current assets and other assets + accrued income – current liabilities and other liabilities – less accrued expenses}) / \text{no. of units outstanding}\]

as at the NAV date NAV of all schemes must be calculated and published at least weekly for closed-end schemes and daily for open-end schemes.

The major factors affecting the NAV of a fund are:

- Sale and purchase of securities
- Sale and repurchase of units
- Valuation of assets
- Accrual of income and expenses

SEBI requires that the fund must ensure that repurchase price is not lower than 93% of NAV (95% in the case of a closed-fund). On the other side, a fund may sell new units at a price that is different from the NAV, but the sale price cannot be higher than 107% of nav.

Also the difference between the repurchase price and the sale price of the unit is not permitted to exceed 7% of the sale price.

4.14.4. **Measuring Mutual Fund Performance:**

We can measure mutual fund’s performance by different method:

- **Absolute Return Method:** percentage change in NAV is an absolute measure of return, which finds the NAV appreciation between two points of time, as a percentage.

23. Review89 1279-1298 odean terrance, 1988, “are investors reluctant to realize their losses?”, journal of finance.
if NAV of one fund changes from **Rs.20 to rs.22 in 12 months**
then absolute return = \( \frac{(22 - 20)}{20} \times 100 = 10\% \)

- **Simple Annual Return Method**: converting a return value for a period other than one year, into a value for one year, is called as animalization. In order to annualize a rate, we find out what the return would be for a year, if the return behaved for a year, in the same manner it did, for any other fractional period.
  e .g: if NAV of one fund changes from **Rs.20 to Rs.22 in 6 months then**
  annual return = \( \frac{(22 - 20)}{20} \times \frac{12}{6} \times 100 = 20\% \)

- **Total Return Method**: the total return method takes into account the dividends distributed by the mutual fund, and adds it to the NAV appreciation, to arrive at returns.
  total return = \( \text{(dividend distributed + change in NAV)/ NAV at the start x } 100 \)
  e .g: if NAV of one fund changes from **rs.20 to rs.22 in 6 months if** in between dividend of Rs. 4 has been distributed then total return = \( \{4 + (22 - 20)\}/20 \times 100 = 30\% \)

- **Total Return When Dividend Is Reinvested** - this method is also called the return on investment (ROI) method. In this method, the dividends are reinvested into the scheme as soon as they are received at the then prevailing.
  NAV (ex-dividend NAV) = \( ((\text{value of holdings at the end of the period/ value of the holdings at the beginning} - 1) \times 100 \)
  E.g. An investor buys 100 units of a fund at Rs. 10.5 on January 1, 2007. On June 30, 2007 he receives dividends at the rate of 10%. The ex-dividend NAV was Rs. 10.25. On December 31, 2007, the fund’s NAV was Rs. 12.25.

  Value of Holdings at the Beginning Period= 10.5*100= 1050
  Number of Units Re-Invested = 100/10.25 = 9.756
  End Period Value of Investment = 109.756*12.25 = 1344.51 Rs.
  Return on Investment = \( ((\frac{1344.51}{1050})-1) \times 100 = 28.05\% \)
• **Compounded Average Annual Return Method:** This method is basically used for calculating the return for more than 1 year. In this method return is calculated with the following formula:

\[ A = P \times (1 + \frac{R}{100})^N \]

Where  
\( P = \) Principal Invested  
\( A = \) Maturity Value  
\( N = \) Period of Investment in Years  
\( R = \) Annualized Compounded Interest Rate In  
\( \%R = \left\{ \left( N \text{TH Root of } \frac{A}{P} \right) - 1 \right\} \times 100 \)

E. G: If Amount Invested Is Rs. 100 & In the End We Get Return of Rs. 200 & Period of Investment Is 10 Years Then Annualized Compounded Return Is 200 = 100 \( (1 + \frac{R}{100})^{10} \) Rate = 7.2 %

2. **Returns:**

Returns have to be studied along with the risk. A fund could have earned higher return than the benchmark. But such higher return may be accompanied by high risk. Therefore, we have to compare funds with the benchmarks, on a risk adjusted basis. William Sharpe created a metric for fund performance, which enables the ranking of funds on a risk adjusted basis.

\[ \text{Sharpe Ratio} = \frac{\text{Risk Premium}}{\text{Funds Standard Deviation}} \]

\[ \text{Treynor Ratio} = \frac{\text{Risk Premium}}{\text{Funds Beta}} \]

Risk Premium = Difference between the Fund’s Average Return and Risk Free Return on Government Security or Treasury Bill over a Given Period.

3. **LIQUIDITY:** most of the funds being sold today are open-ended. That is, investors can sell their existing units, or buy new units, at any point of time, at prices that are related to the NAV of the fund on the date of the transaction. Since investors continuously enter and exit funds, funds are actually able to provide liquidity to investors, even if the underlying markets, in which the portfolio is invested, may not have the liquidity that the investor seeks.
4. **EXPENSE RATIO**: expense ratio is defined as the ratio of total expenses of the fund to the average net assets of the fund. Expense ratio can actually understate the total expenses, because brokerage paid on transactions of a fund are not included in the expenses. According to the current SEBI norms, brokerage commissions are capitalized and included in the cost of the transactions.

\[
\text{Expense Ratio} = \frac{\text{Total Expenses}}{\text{Average Net Assets}}
\]

5. **COMPOSITION OF THE PORTFOLIO**: credit quality of the portfolio is measured by looking at the credit ratings of the investments in the portfolio. Mutual fund fact sheets show the composition of the portfolio and the investments in various asset classes overtime. Portfolio turnover rate is the ratio of lesser of asset purchased or sold by funds in the market to the net assets of the fund. If portfolio ratio is 100% means portfolio has been changed fully. When portfolio ratio is high means expense ratio is high.

\[
\text{Portfolio Ratio} = \frac{\text{Total Sales \& Purchase}}{\text{Net Assets of Fund}}
\]

In order to meaningfully compare funds some level of similarity in the following factors has to be ensured:
- Size of the funds
- Investment objective
- Risk profile
- Portfolio composition
- Expense ratios

4.15. **Taxation of Mutual Funds and Investors**-

The taxation of the mutual fund and the investors is according to the provisions of the income tax act, 1961 (“ITA”).

4.15.1. **Taxation Of Mutual Fund**-

An Indian mutual fund registered with the SEBI, or schemes sponsored by specified public sector banks / financial institutions26 and approved by the central government or authorized by the RBI are tax exempt as per the provisions of section 10(23d) of the ITA. The mutual
fund will receive all income without any deduction of tax at source under the provisions of section 196(iv), of the ITA.

4.15.2. Taxation Of Resident Unit Holders

(I) Capital Gains

Under section 2(42a) of the ITA, a unit of a mutual fund is treated as a long-term capital asset if the same is held for more than 12 months. Under section 112 of the ITA, capital gains chargeable on transfer of long-term capital assets are subject to tax at the rate of 20%. The capital gains will be computed by deducting the following amounts from the sale consideration:

- expenditure incurred wholly and exclusively in connection with such transfer, and
- cost as inflated by the cost-inflation index notified by the central government of India in case of resident unit-holders.

In case of an individual or Hindu undivided family (“HUF”), being a resident, where the total income as reduced by the long-term capital gains is below the maximum amount not chargeable to tax, the long-term capital gains shall be reduced to the extent of the shortfall and only the balance long-term capital gains will be subject to the flat rate of taxation. However, the maximum tax payable on long-term capital gains on units is restricted to 10% of capital gains of capital gains calculated without indexation of cost. In addition to the aforesaid tax, a surcharge of 5% of such tax liability is also payable.

The capital loss resulting from sale of units would be available for setting off against other capital gains made by the investor and would reduce the tax liability of the investor to that extent. However, losses on transfer of long-term capital assets would be allowed to be set off only against gains from transfer of long-term capital assets and the balance long-term capital loss shall be carried forward separately to be set-off only against long-term capital gains.

(ii) Dividends

Under section 194k of the ITA, a mutual fund is required to deduct tax at source at the rate of 10.5% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in excess of Rs.
1,000 during the financial year in case of resident unit-holders. However, if the unit-holder submits a declaration as prescribed under section 197a of the ITA, then no tax will be deducted from any income distributed by the mutual fund subject to the condition that income so distributed does not exceed the maximum income not chargeable to tax under the ITA.

In case of resident unit-holders, no tax is required to be deducted at source from capital gains arising at the time of repurchase or redemption of units.

4.15.3. **Taxation Of Non-Resident Individual Unit Holders**

**(I) Capital Gains**

Any long-term capital gains received by a non-resident individual investor is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 112 of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 31.5% (including of a surcharge of 5%).

**(ii) Dividends**

A mutual fund is required to deduct tax at source, as per section 196a of the ITA, at the rate of 21% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in case of non-resident individual unit-holders.

However, in case of non-resident unit-holders, if provisions of the double taxation avoidance agreement ("DTAA") are more beneficial, then the tax deducted would be at the rate provided in the DTAA.

4.15.4. **Taxation of Non-Resident Unit Holders Being A Company**

**(I) Capital Gains**

Any long-term capital gains received by a non-resident investor, being a company, is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 112 of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 42% (including of a surcharge of 5%).

24. As Defined Under Section 10(23D) Of The ITA.
(iii) Dividends

A mutual fund is required to deduct tax at source, as per section 196a read with section 115a of the ITA, at the rate of 21% (including surcharge of 5%) on any income credited or paid on or after June 1, 2002 in case of non-resident unit-holders, being a company. However, in case of non-resident unit-holders, if provisions of the DTAA are more beneficial, then the tax deducted would be at the rate provided in the DTAA.

4.15.5. Foreign Institutional Investors-

(I) Capital Gains
Any long-term capital gains received by a foreign institutional investor ("FII"), being a company, is subject to tax at the rate of 10.5% (including a surcharge of 5%), as per section 115ad of the ITA. In respect of short-term capital gains, tax is required to be deducted at source at the rate of 31.5% (including of a surcharge of 5%).

(ii) Dividends
A mutual fund is required to deduct tax at source at the rate of 21% (including a surcharge of 5%) on any dividends paid to an FII.

4.15.6. OVERSEAS INVESTMENT IN THE DOMESTIC MUTUAL FUND SECTOR

Depending on the objective, there are broadly two ways in which overseas investors can participate in the domestic mutual fund sector. If the objective is to set up mutual fund operations and raise funds from domestic investors, the first alternative can be used and if the objective is to invest in Indian capital markets, the second alternative may be used.

4.15.6.1 Setting up Your Own AMC and Mutual Fund

In the recent years, there has been an increasing trend in India towards globalization of the mutual fund industry. Several reputed international asset managers have forged tie-ups with leading Indian institutions and fund managers. Some of these international players have decided to venture into the Indian mutual fund market independently and have established their own operations in India.

The mutual fund regulations do not restrict entry of any foreign asset manager into India and several of the international players like prudential of UK, Alliance, ANZ Grindlays, Ingbaring, etc. Have set up shop in India.

However, the important factor that one needs to consider while setting up operations in India is the foreign investment guidelines prescribed by the foreign investment promotion board (“FIPB”). Under the present guidelines issued by the FIPB for foreign investment into India, asset management activity is part of the definition of non-banking finance activity. Certain minimum capitalization norms have been laid down for foreign investment in such non-banking finance companies (“NBFCs”). These capitalization norms are as follows:

<table>
<thead>
<tr>
<th>Foreign Holding as a Percentage of Equity Minimum Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Up To 51% Foreign Equity</td>
<td>US$ 500,000</td>
</tr>
<tr>
<td>Between 51% And 75%</td>
<td>US$ 5 Million</td>
</tr>
<tr>
<td>More Than 75% Foreign Equity</td>
<td>US$ 50 Million</td>
</tr>
</tbody>
</table>

In the light of the high capitalization requirements, several of the international players have elected to enter the market via a joint venture with a domestic partner, despite their desire to retain 100% control over their Indian investments. A number of interesting structures could be evolved to strike a balance between the retention of operative control over the AMC and prescribed capitalization requirements. Investment in this sector is under the automatic route whereby no prior approval of the FIPB would be required for setting up the AMC. However, there are some post-facto filing requirements with the reserve bank of India that need to be complied with.

### 4.15.6.2 Investing via a Domestic Mutual Fund (“Offshore Fund Structure”)

Offshore mutual funds that may not want to set up operations in India but are interested in participating in Indian capital markets can do so by investing through a scheme of an existing domestic mutual fund. A typical structure for this kind of investment can be graphically represented as under:
An investment fund ("overseas fund") is often set up in a tax favorable jurisdiction and will subsequently invest all the monies it raises from overseas investors into a scheme set up by an Indian mutual fund ("scheme"). The scheme is fully dedicated to the overseas fund, i.e. all the units of the scheme are issued only to the overseas fund. The scheme will then invest in the securities of Indian companies. The scheme can be managed by the domestic AMC. Innovative management structures can be evolved if there is an overseas investment manager who wishes to participate in the management of assets of the scheme.

The scheme and the overseas fund have to be registered with SEBI. Once they are registered with SEBI no further approvals for making any down-line investments are required.

SEBI approval to the overseas fund and the domestic scheme is largely based on the fulfillment of the following criteria:

1. The overseas fund is a broad-based fund
2. The approval of the RBI and the ministry of finance under section 115ab of the income-tax act, 1961 has been obtained.
3. The scheme should report its net asset value on a monthly basis
4. The investment management agreement is put on records of the SEBI.

In this context, it is pertinent to note that the above restrictions placed on investment management and advisory services will not be
applicable; neither are the minimum capitalization requirements mandatory in such cases.

The aforesaid structure has been very successfully used by domestic mutual funds that want to raise funds from overseas investors for investing in Indian securities. UTI And several other domestic mutual funds have floated offshore funds using the above structure. One of the benefits of establishing an overseas fund has been the tax advantage endowed upon the investor pursuant to the Indo-Mauritius double taxation avoidance agreement (“Mauritius DTAA”).

4.15.6.3. Foreign Institutional Investment (“FII”) In the Indian Mutual Fund Market -:

In September 1992, the government of India issued guidelines which enable foreign institutional investors, including institutions such as pension funds, investment trusts, asset management companies, nominee companies and incorporated/institutional portfolio managers, to make portfolio investments in all securities of listed and unlisted companies IN India including the units of a mutual fund.

Under the guidelines, all FII must be registered with the securities and exchange board of India and obtain a general permission from the reserve bank OF India under the foreign exchange management act, 1999. However, since the securities and exchange board of India provides a single window clearance; a single application must be made to the securities and exchange board of India.

FII is required to comply with the provisions of the securities and exchange board of India (foreign institutional investors) regulations, 1995, (“SEBI FII regulations”) or foreign institutional investor regulations. A registered foreign institutional investor may, subject to the ownership restrictions discussed below, freely buy and sell securities issued by any Indian company, realize capital gains on investments made through the initial amount invested in India, subscribe to or renounce rights offerings for shares, appoint a domestic custodian for custody of investments made and repatriate the capital, capital gains, dividends, income received by way of interest and any compensation received towards sale or renunciation of rights offerings of shares.
The securities and exchange board of India and the reserve bank of India regulations restrict portfolio investments in Indian companies by foreign institutional investors, nonresident Indians and overseas corporate bodies, all of which we refer to as foreign portfolio investors. An FII may purchase equity shares of each company in which it has invested on his own account not exceeding 5% of the total issued capital of that company. In respect of a FII investing in equity shares of a company on behalf of his sub-accounts, the investment on behalf of each such sub-account shall not exceed 5% of the total issued capital of that company. However, in case of foreign corporate or individuals, each of such sub-account shall not invest more than 5% of the total issued capital of the company in which such investment is made.

4.15.6.4. **Investment into the Indian Mutual Fund Market via Mauritius:**

Of the many jurisdictions that are considered tax-favorable for inbound investments into the Indian economy, Mauritius is almost unequivocally the first choice and is India's largest investor. In contrast, investments made directly into the Indian market by nations like the United States have registered a deceleration.

India signed the DTAA with Mauritius on August 24, 1982. Pursuant to the Mauritius DTAA, capital gains earned by ordinary offshore companies organized in Mauritius on divestments made from Indian companies will not be taxed in India, subject to certain preconditions, i.e. if the Mauritius company does not have a permanent establishment in India. The India Mauritius tax treaty also does not contain a limitation of benefits provision (otherwise known as the anti-treaty shopping clause). Politically it is considered more stable than some other jurisdictions with which India has favorable tax treaties.

Apart from its reputation as a "clean" jurisdiction, Mauritius is also perceived to be a comparatively low-cost offshore alternative for investments directed into the South East Asian region. In addition to the DTAA it has entered into with India, Mauritius has signed approximately twenty comprehensive double tax treaties, excluding the number of treaties pending negotiation. This, combined with the fiscal incentives -
some of which are mentioned herein below - makes Mauritius a favored jurisdiction for international tax planning.

It is pertinent to note that all companies incorporated in Mauritius are treated as tax resident in Mauritius. It is necessary, however, to ensure that substantial management control vests in the resident directors of the Mauritius company, so that the validity of its presence is unquestioned. This can be affected in various ways, such that the balance of control is achieved to the satisfaction of the overseas investor. In addition to the fact that Mauritius does not tax capital gains accruing to its residents, ordinary companies pay tax at the rate of 15% of their income excluding capital gains. However such however such companies are eligible for a deemed foreign tax credit to the extent of 90% of the Mauritius tax liability till the year 2003. There are no other "hidden costs", such as stamp duties or levies. No withholding taxes are levied on dividends, interests and royalties.

However, in the recent times the India-Mauritius DTAA has been under a storm. The lower tax authorities IN India attempted to deny the India-Mauritius DTAA benefits to some Mauritius resident companies, challenging their residency in Mauritius. Since tax treaties are a part of international law and have to be honored by the treaty partners, India’s ministry of finance issued a circular confirming the availability of the benefits under the India-Mauritius DTAA to residents of Mauritius who hold the requisite tax residency certificate issued by the income-tax authorities in Mauritius. It concerned the clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius double tax avoidance convention (DTAC). The relevant part of the circular is reproduced as under:

"...Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly...accordingly, FII's etc.

Certain non-profit organizations in India has filed the public interest litigations ("PILs") with the Delhi high court against the Indian
government challenging the circular. The Delhi high court allowed the PILs and struck down the circular issued by the CBDT on the grounds that the CBDT has exceeded its powers in issuing the circular.

The Indian government and global business institute. Filed an appeal before the supreme court of India against the said Delhi high court order. The appeal came up for hearing before the supreme court on November 18, 2002 and the supreme court, while admitting the appeals, stayed the operation of the Delhi high court order till it passed further orders. As a result of this, the circular is reinstated into force. Based on Indian judicial decisions and international law31. We believe that there are strong chances that global business institute and the government of India would succeed in the appeal.

Further, India has also signed more favorable treaties with UAE and Cyprus during the past few years and is therefore unlikely to put Mauritius in a less favorable position as compared to those countries. Therefore, it is unlikely that the India-Mauritius tax treaty can be renegotiated. However, it would be important to give careful consideration to structuring of investment through Mauritius in order to minimize the risk of denial of India-Mauritius DTAA benefits.

4.16. Recent Developments -:

4.16.1. Investment in Foreign Debt

SEBI has permitted the Indian mutual funds to make investments in foreign debt securities. As per the circular issued by SEBI, mutual funds have been allowed to invest in foreign debt securities with highest credit rating (such as a-1/AAA by standard and poor, p-1/AAA by moody’s, f1/AAA by Fitch IBCA, etc.) In the countries with fully convertible currencies provided the guidelines laid down in the circular are complied with. Similarly, the Indian mutual funds have also been permitted to make investments in non-Indian government securities where the countries are AAA rated.

26 Circular No. 789, April 13, 2000 243 ITR (St) 57
27 A not for Profit Corporation incorporated under the Mauritius corporate laws.
28 On the principle of pacta sunt servanda, parties to an international treaty must honour their obligations in good faith.
29 Circular no. MFC/CIR/17/419/02 dated March 30, 2002
However, such investment is permitted subject to an overall cap of 10% of the net assets of a mutual fund, subject to the maximum of USD 50 million, per mutual fund for making investments in the foreign debt securities and American depository receipts/global depository receipts issued by Indian companies (“ADRS/GDRS”).

This has opened up newer opportunities for domestic mutual funds for investing in foreign securities. This also enables mutual funds to hedge their country risk by spreading their investments amongst different countries. Several funds have announced schemes for such overseas investments.

4.16.2. Investment by Resident in Foreign Securities

The Reserve Bank of India, as a part of its ongoing liberalization and with a view to usher in full convertibility of rupee, has recently permitted Indian residents, including mutual funds, subject to an overall cap of USD 1 billion. Such investment will have to be made in foreign companies whose shares are listed on an overseas exchange and which has at least 10% holding in an Indian company which is also listed on the Indian stock exchange. While these conditions may sound restrictive, it is only a matter of time when the RBI will look at further relaxations. This has opened up an opportunity for Indian investors to invest in the overseas market and this also throws up an opportunity for mutual funds to tap into these investments since individual investors would be more comfortable to invest through a mutual fund Vis-À-Vis a direct exposure to foreign securities.

4.16.3. Compulsory Certification of Sales/Marketing Personnel

SEBI together with the association of mutual funds of India has made it mandatory for the sales and marketing personnel of mutual funds to obtain a certification. This requires such personnel to appear for a test which is currently conducted by the amfi. The move is to educate the sales personnel on the basics of investment and on the current regulations so as to ensure that no false representations are made to the investors by the sales personnel and is a move towards bringing in more accountability to the asset management company.
4.16.4. Mutual Fund Schemes for Real Estate

AMFI has recently submitted to SEBI, draft guidelines for allowing mutual funds to invest in real estate. The move is in response to a growing need of the real estate sector and also the fact that this sector has provided to be an attractive investment opportunity for investors. Real estate investment trusts (REITs) are a popular investment vehicles in the development markets of the us and the UK and have contributed significantly to the Development of those economy. A need was felt for implement such REITs structure in India and in response to that SEBI constituted a committee to examine the current regulations governing mutual funds and to recommend a set of guidelines for setting up schemes under the current framework for investing in real estate. The report has been submitted by the committee to the SEBI which has been put-up for public comments. It is expected that shortly, the SEBI would notify these new set of regulations.

4.16.5. Splitting Up Of UTI

An ordinance was recently passed by the president of India which repealed the unit trust of India act, 1963 thereby splitting UTI into two funds viz. UTI i and UTI ii. The ordinance was issued in wake of the severe payment crisis that UTI had faced on account of its assured return schemes which resulted in an adverse impact to the Indian capital markets. UTI being the first mutual fund set-up in India has always been a symbol of trust and currently is the largest mutual fund in India. Also, since it was constituted under a special enactment, it was not strictly governed by the SEBI regulations. A need was felt to bring UTI within the SEBI purview and also to ensure that the units are made NAV linked. UTI i now consists of all assured return scheme (including us 64) whereas UTI ii now consists of all other schemes which are NAV linked. UTI i has a government guarantee and will be managed by an AMC formed by the life insurance corporation of India, the bank of Baroda and the Punjab national bank. Over a period of time, the asset management function of UTI ii will be privatized.
CONCLUSION

The Indian mutual fund industry is beginning to blossom and with the recent relaxations it is evident that the industry will rise to the international standard. India as a country holds great potential and the rise in income and savings levels signify the tremendous growth opportunity that lies ahead.

The very presence of most significant international player in India demonstrates that they cannot afford to ignore the Indian market if they want to maintain their positions internationally. Also, Indian market has provided to be a good investment destination which has attracted foreign players to invest in Indian securities. Relaxation in exchange controls and consultative approach to formation of regulatory framework has given several international mutual fund players a comfort in the Indian economy which is driving their desire to set-up operations in India. Indian mutual fund

Industry can look forward to exciting times ahead and the current consolidation phase will result in only the serious players a long term commitment to India exist.
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