CHAPTER 2
SURVEY OF ALLIED RESEARCHES
2.1. Origin and Concept of Mutual Funds:

2.1.1 Definition of Mutual Fund

A mutual fund is a special type of investment institution that acts as an investment conduit. It pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. Mutual funds issue securities (known as units) to the investors (known as unit-holders) in accordance with the quantum of money invested by them. The profits (or losses) are shared by the investors in proportion to their investments (Khan and Jain, 2006). A mutual fund is a collective investment arrangement (Chandra P, 1997). The basis of a mutual fund is the 'pooling' concept. In other words, mutual funds pool money from a cross-section of investors by issuing units, constructs a diversified portfolio of stocks, bonds and other investment instruments, and invests the same in the capital market (Sadak H, 2003). A mutual fund is an investment vehicle that pools the money of hundreds or thousands or even millions of different investors and uses it to buy securities, such as stocks, bonds, short-term loans in the money markets, foreign securities or even gold or real estate (Rowland M, 2001).

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is invested by the fund manager in different types of securities depending upon the objective of the scheme. These could range from share to debentures to money market instruments (Roy S, 2007). Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time.
Mutual fund issues units to the investors in accordance with quantum of money invested by them (Amfi, 2006).

The income earned through these investments and the capital appreciation realized by the scheme is shared by its unit holders in proportion to the number of units owned by them (pro-rata). Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed portfolio at a relatively low cost (Roy S, 2007).

Anybody with an investible surplus of as little as a few thousand rupees can invest in Mutual Funds. Each mutual fund scheme has a defined investment objective and strategy. A mutual fund is the ideal investment vehicle for today's complex and modern financial scenario. Markets of equity shares, bonds and other fixed income instruments real estate, derivatives and other assets have become mature and information driven. Price changes in these assets are driven by global events occurring in far away places. A typical individual is unlikely to have the knowledge, skills, inclination and time to keep track of events, understand their implications and act speedily. An individual also finds it difficult to keep track of ownership of his assets, investments, brokerage due and bank transactions etc.

A mutual fund is the answer to all these situations. It appoints professionally qualified and experienced staff that manages each of these functions on a full time basis. The large pool of money collected in the fund allows it to hire such staff at a very low cost to each investor. In effect, the mutual fund vehicle exploits economies of scale in all three areas— research, investments and transaction-processing (BFSI@Kolkata, 2007).
2.1.2 History of Mutual Funds

The origin of mutual funds can be traced back to a little more than one and half century ago. In 1822, King William I of the Netherlands formed “Societe Generale de Belique”, at Brussels, which appears to be the first mutual fund. It was intended to facilitate small investments in foreign government loans, which then offered more security and returns than the home industry. Later on, another similar company was started with an objective to make cooperative investments, to protect investors against loss by wide undertakings, and to secure larger returns through investing in industries.

While the mutual funds had its origin in Belgium, it did not take firm root in continental soil but flourished when transplanted in UK and USA surroundings (IIBF, 2007).

2.1.3 Mutual Fund – International Scenario

- Mutual Fund Industry in UK

The very first investment trust, Foreign & Colonial, set out its investment aims “to give investors of moderate means, the same advantages as the large capitalist ” in its prospectus of 1868. 1880s was the period of boom for this innovative investment opportunity in UK. Though some investment trusts failed during the British crash of 1890, most of them survived. By 1900 there were more than 100 investment trusts, many of them are still around. These investment trusts are close-ended funds.

During the first period of its operation (till mid-1920s) mutual funds were in formative and experimental conditions. They were incorporated under the Companies Act. The years from 1900 to 1914 were marked by an increasing tendency on the part of British investment manager to invest
their clients’ funds in American securities, especially in stocks and bonds of American railways. With the advent of the First World War, this situation changed drastically. From 1914-1918, British mutual funds sold a large proportion of their investments and was promptly invested in the war loans of the British government.

In United States many small investors lost their fortunes in the years following the Wall Street crash of 1929. But not even one investment trust failed during those troubled years (1890s) in UK. However, some structural changes started taking place in the industry. The most important one was the emergence of unit trusts. Unit trusts are created by a trust deed. The first unit trust appeared in 1931, shortly after the Wall Street crash.

Investment trusts continued to be popular with private investors’ right up until the middle of 1960s. The unit trust industry expanded rapidly till October 1987 crash. These trusts became popular mainly because of the range of investment opportunities they made available to the investors.

The stock market crash at the end of 1987 brought significant changes in the unit trust industry. The other main event affecting the unit trust industry during and post 1988 is the implementation of The Financial Services Act. The Financial Services Act brought the investors’ greater protection and larger number of restrictions on the industry.

In the last decade, lots of changes have been observed in the industry. Investors are demanding better levels of services, transparency in prices and more product variety. The competition in the UK Fund industry has increased due to low entry barriers encouraging new players. The increased level of competition is putting pressure on prices. The mutual
fund industry in UK is witnessing a restructuring wave and the outcome is powerful brand leaders (IIBF, 2007).

- **Mutual Fund Industry in US**

The origin of mutual funds in the USA could be traced to the private trustee system in Boston during the second half of 19th century. One of the first investment trusts, The Boston Personal Property Trust was organized in 1893. It was the Alexander Fund established in Philadelphia in 1907 by W. Wallace. Alexander that seems to have originated many of the ideas adopted by mutual funds.

In the USA, mutual fund industry evolved in three phases.

1. Pre 1940,
2. 1940-1970, and
3. 1970 to the present.

The first stage i.e. period before 1940 was the stage of infancy of the mutual fund industry. Mutual funds, in those days, were small and dissimilar to the extent that these entities were not even given the status of a separate industry. Close-ended funds were the dominant form of mutual fund to mobilize money. However, by the end of 1940’s the share of close-ended funds started shrinking in favor of open ended funds.

In the second stage, assets managed by mutual funds witnessed rapid and steady growth and mutual fund evolved into an established industry.

The most striking feature of the phase (1970 to present) has been the innovation in the investment objectives. Till this phase most of the money was mobilized under the objective of providing the benefit of
diversification in equity investing. While there were five types of funds offered in 1970, there were 22 different types in 1987. The money market mutual fund is considered the most innovative launch of that time. It widened the scope of competition for mutual funds with banks on account of similarity in the product. Another important happening of that time was the innovative steps taken by the funds to improve the quality of investor servicing. Another significant development post-1970s has been the reduction or elimination of sales loads, thereby increasing the mobility of investors.

The total assets under management by the end of 1997 were $4465 billion managed by 6900 funds. The decade 1990-2000 was particularly favorable to mutual fund industry in USA as by the end of 2000 the assets managed by the industry increased to $7 trillion. The increased demand for mutual funds in the 1990’s led to the creation of a large number of mutual funds. The number rose from around 2900 at the beginning of the decade to above 8200 by the end of 2000. The number of households owning mutual funds reached to 50.6 million in 2000 as against 23.4 million in 1990. World equity funds were also an important element in the growth of mutual funds, as investors increasingly sought to diversify their financial assets through overseas investments. With the rising demand for mutual funds in the 1990’s fund companies and distribution companies developed new outlets for selling mutual funds and expanded traditional sales channels. Funds that were traditionally sold through a sales force of brokers shifted increasingly to non-traditional sources of sales such as employee-sponsored pension plans, banks and life insurance companies in the 1990’s (IIBF, 2007).
2.1.4 Objectives of Mutual Fund

The objectives sought to be achieved by mutual funds are as follows:

(a) To provide an opportunity for lower income groups to acquire without much difficulty property in the form of shares.

(b) To cater mainly to the need of individual investors whose means are small.

(c) To manage investors’ portfolios in a manner that provides regular income, growth, safety, liquidity and diversification (ICFAI, 2007).

Small investors face a lot of problems in the share market- limited resources, lack of professional advice, lack of information etc.

Mutual funds have come as a much needed help to these investors. It is a special type of institutional device or an investment vehicle through which the investors pool their savings which are to be invested under the guidance of a team of experts in wide variety of portfolios of corporate securities in such a way, so as to minimize risk, while ensuring safety and steady return on investment. It forms an important part of the capital market, providing the benefits of a diversified portfolio and expert fund management to a large number of investors (particularly small investors) (IIBF, 2007).

2.1.5 Features of Mutual Fund

Mutual Fund as an investment instrument has the following features:

(a) Professional Management: Professional money managers research, select and monitor the performance of the securities the fund
purchases. Mutual funds provide the services of experienced and skilled professionals, backed by a dedicated investment research team that analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme (Roy S, 2007).

(b) Diversification: Diversification is an investing strategy that can be neatly summed up as "Don't put all your eggs in one basket". Spreading our investments across a wide range of companies and industry sectors can help lower our risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds. In fact, mutual funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. An investor can achieve this diversification through a mutual fund with far less money (Roy S, 2007). If an investor is going to invest in different mutual funds, one has to ensure that he invests in different asset classes and styles in order to reduce risk and take advantage of diversification (Katz D, 2006). Diversification is not restricted to investments in different mutual funds. Diversification also involves cross border investments. There are three ways an investor in India can take part in the global investing scenario via mutual funds. One is via a Feeder fund. This is a fund that conducts virtually all of its investing through another fund which is called the master fund. So, the units of the fund will be sold by the feeder fund but invested through the corresponding master fund. Another option is a Fund of Funds. A mutual fund will not buy stocks directly but invest in other
mutual funds. The third option is to select funds that directly invest in stocks abroad (Mutual Fund Insight, 2007).

(c) Affordability: Some mutual funds accommodate investors who don't have a lot of money to invest by setting relatively low rupee amounts for initial purchases, subsequent monthly purchases, or both. Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy (Roy S, 2007).

(d) Liquidity: Mutual fund investors can readily redeem their shares at the current NAV—plus any fees and charges assessed on redemption—at any time. In open-end schemes, the investor gets the money back promptly at net asset value related prices from the mutual fund. In closed-end schemes, the units can be sold on a stock exchange at the prevailing market price or the investor can avail the facility of direct repurchase at NAV related prices by the mutual fund (Roy S, 2007).

(e) Convenient Administration: Investing in a mutual fund reduces paper work and helps an investor avoid many problems such as bad deliveries, delayed payments and follow up with brokers and companies. In fact, mutual funds save our time and make investing easy and convenient (Roy S, 2007).

(f) Choice of Schemes: Mutual funds offer a family of schemes to suit an investor’s varying needs over a lifetime (Roy S, 2007). An innovative approach to choosing of schemes uses core and satellite route for wealth creation. The core and satellite approach allows the core portfolio to play the key role and the satellite portfolio takes on
a supporting role. Tried and tested schemes with a sound record can form the core part of the portfolio. Satellite is the return kicker of the portfolio (Adajania K, 2006).

(g) Flexibility: Through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, an investor can systematically invest or withdraw funds according to his needs and convenience (Roy S, 2007).

(h) Transparency: An investor may get regular information on the value of his investment in addition to disclosure on the specific investments made by the scheme, the proportion invested in each class of assets and the fund manager’s investment strategy and outlook (Roy S, 2007).

(i) Return Potentials: Over a medium to long-term, mutual funds have the potential to provide a higher return as they invest in a diversified basket of selected securities (Roy S, 2007).

(j) Low Costs: Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors (Roy S, 2007).

(k) Well regulated: Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of mutual funds are regularly monitored by SEBI (Roy S, 2007). If an investor wishes to invest Rs. 50,000 or more in a mutual fund, compliance with KYC (Know Your Customer) norms is mandatory. KYC norms have been put in place to prevent money laundering. An investor can download
a KYC form from the Amfi or any mutual fund’s website (Shah. B, 2008).

2.1.6 Types of Mutual Fund

1. Types of scheme by Tenor

2. Types of scheme by Asset Class

3. Types of scheme by Position Philosophy

4. Types of scheme by Geography

5. Fund Of Funds Schemes

1) Types of Scheme by Tenor

Open-end Schemes

These are schemes that do not have a fixed maturity. The mutual funds ensure liquidity by announcing sale and re-purchase prices for the units of such a scheme on an ongoing basis.

Investors who wish to exit from an open-end scheme can offer their units to the mutual fund for redemption, generally called re-purchase. Similarly, the mutual fund can sell new units to investors’ desires of participating in the scheme, generally called sale.

Additionally, a mutual fund can choose to provide liquidity by listing the scheme in the stock market. In such a scenario, investors can either trade in the market, in which case there is no change in unit capital of the scheme or opt for the sale and re-purchase route, in which case the unit capital of the scheme is impacted (Sankaran.S, 2007).
Continuous inflow of funds may have a situation where fund managers don’t find convincing stock ideas and so are forced to hold cash. This is a double-edged sword. If the market falls, schemes with a high cash allocation typically fall the least. However, if the market rises suddenly, funds with higher cash allocation lag behind (Adajania. K, 2007).

Open-ended mutual funds recognising the need to take only as much corpus as can be efficiently handled, can close its window or further sale of units for a short span of time. It optimises returns while reducing volatility (Adajania K, 2006). Small and mid cap funds tend to underperform when the corpus is bloated (Bhope T, 2005).

**Close-end Schemes**

These are schemes that have a fixed maturity. Liquidity in such schemes is available through listing in the stock market. Trades in the market entail change in the ownership of the units, but do not alter the scheme’s unit capital.

Occasionally, close-end schemes provide a re-purchase option to investors, either for a specified period or after a specified period, normally up to a total limit for all investors together or a limit per investor (Sankaran.S, 2007). Some investors may not find the idea of a closed-end fund appealing because these funds usually have a single-point agenda: to built wealth over a longer period. These funds may offer investment options that open-end funds cannot, including the chance to invest in illiquid securities. Also, closed-end funds are usually less volatile during market swings than regular mutual funds. (Adajania K, 2006).
2) Types of scheme by Asset Class

Equity Schemes

Equity schemes invest primarily in shares. Depending on the scheme objective, investments could be in (1) Growth Stocks, where earnings growth is expected to be attractive, (2) Momentum Stocks that go up or down in line with the market, (3) Value Stocks, where the fund manager is of the view that current valuations in the market do not reflect intrinsic value or (4) Income Stocks, that earn high returns through dividends.

Income stocks offer capital appreciation as well as cash payments. Any company that pays a substantial portion of its earnings in dividends is reinvesting less and will grow at a slower pace than growth stocks who pay less by way of dividend and reinvest their earnings to sustain their growth (Mutual Fund Insight 2008).

Equity Linked Saving Scheme (ELSS)

ELSS is like any other diversified equity fund but investors can avail tax benefits, provided the investment is locked in for a period of 3 years. Unlike assured return schemes, ELSS does not guarantee returns (Abraham S, 2007). ELSS fund managers take long term calls on their investments. So, the fund manager adopts a buy and hold strategy to capitalise on growth. ELSS yields the highest return if invested at the onset of a bull run (Bhope T, 2005). If an investor is investing in an equity linked savings scheme it is better to avoid dividend reinvestment. Each dividend that is reinvested is locked for three years. In effect, an investor may never fully be able to withdraw his investment (Adajania K, 2006).
their short-term cash surpluses. They do not mark-to-market their portfolios and are generally cushioned from market volatility (Adajania K, 2006).

There is an inverse relationship between price of bond and interest rate rise. Fund managers use a formula called ‘price value of a basis point’. (PVBP) to estimate the extent to which bond prices will fall if there is a 1 basis point (0.01%) rise in interest rates (Bhope P. Tejas, 2005). If one is a risk averse investor and would like to take the least possible risk with his capital, the first thing he needs to decide is tenure. As short term instruments are less prone to the risk of interest rate volatility, the investor should centre his investments round the short term and stay put till interest rate stabilises (Adajania K, 2006).

There is no clear and uniform way of valuing debt securities in India. The same security could be valued differently in different funds’ portfolio at the same time if it is illiquid, thinly-traded and doesn’t have a market price. Some securities (basically those traded on the NSE’s debt market) do have an ISIN (International Securities Identification Number) code, but not all do. In any case funds do not list securities by ISIN in their portfolio revelations. The lack of a clear identity of securities makes Indian debt fund portfolio revelations a statutory obligation that does not help investors in any meaningful way (Mutual Fund Insight, 2009).

**Balanced Schemes**

Balanced schemes invest in a mix of equity and debt. The debt investments ensure a basic interest income, which the fund manager hopes to top up with capital gains on the investment portfolio (Sankaran.S, 2007). The fixed income part is generally corporate or government debt
of various types. These funds are mandated to stick to a fairly well defined ratio between these two types of assets. Balanced Funds typically invest up to 65% in equity and the rest in debt (Chaturvedi. P. Ved, 2006). If a balanced fund keeps its equity allocation above 65% then the investors’ entire investment is treated as equity for tax purposes and thus becomes free from long-term capital gain tax (Mutual Fund Insight, 2009). A balanced fund can be used for a variety of investment functions such as asset allocation and diversification by holding a portfolio that is diversified between equity and debt, portfolio rebalancing through periodic selling and buying in the equity and debt portions of the portfolio to bring the allocation between them to acceptable levels, and of course, for the primary function of earning equity linked returns with lower volatility than pure equity funds (Abraham S, 2008).

Balanced funds target the risk averse investor who is not willing to put all his money and who relies on fund managers since they are obviously better equipped to take advantage of market conditions (Bhope T, 2005).

**Capital Protected Schemes:** A capital protected scheme is a kind of balanced scheme where a part of the initial issue proceeds is invested in gilts that would mature to a value equivalent to the unit capital of the scheme. Thus, the investors’ capital is protected. The remaining issue proceeds (excess over what is required to be invested in gilts for capital protection) are invested in risky investments.

Under SEBI regulations, capital protection schemes can only be structured as closed-end schemes (Sankaran.S, 2007).
3) Types of scheme by Position Philosophy

Sector Funds

Regular Equity Funds invest in a mix of equities that are spread across different sectors. Therefore they are often referred to as diversified equity funds. Sector funds, are expected to invest in only a specific sector. For instance an energy fund would only invest in energy companies (Sankaran.S, 2007). By there very definition sector funds are not diversified so the performance of the chosen sector determines the fortune of the funds. If the sector is doing well the portfolio in the sector scheme gains but if the sector is fairing badly the portfolio loses as the stocks in the sector lose sheen. Sector funds in India came up in the year 1999-2000. The sector funds tend to be exposed to a handful of well managed companies stocks. Again, there may be enough number of quality stocks to invest in but all of those might not be large caps. Small and mid cap stocks are illiquid and needless to say they add an extra element of risk to the already risky sector funds (Bhope T, 2006). With sector funds investors must make no mistake in deciding when to enter and exit these funds, which, is in direct contrast to the convenience that mutual funds are suppose to offer (Mehra. P, 2008).

Index Funds

Index funds seek to have a position that replicates an identified index, say, BSE Sensex or NSE Nifty. Such a position can be created through either of two methods: it can either be done by maintaining an investment portfolio that replicates the composition of the chosen index. This replicating style of investment is called passive investing. Index funds are therefore often called passive funds. Index schemes are also referred to as...
unmanaged schemes (since they are passive) or tracker schemes (since they seek to track a specific index).

Alternately mutual funds, through its research can identify a basket of securities and / or derivatives whose movement is similar to that of the index. Schemes that invest in such baskets can be viewed as active index funds (Sankaran.S, 2007).

**Enhanced Index Funds**

The Enhanced Index Funds is a managed index fund that seeks to beat the performance of its benchmark index by at least 0.1% but not more than 2%. If the index funds performance were to exceed this 2% cap it would then be considered an equity mutual fund (Sankaran.S, 2007).

**Exchange Traded Funds (ETFs)**

ETFs are open-end funds that trade on the exchange. Like index funds, ETFs are benchmarked to a stock exchange index. An ETF is traded in the market place. Therefore its unit price keeps changing during the day. (Sankaran.S, 2007). Gold ETFs are open-ended mutual fund schemes that will invest the money collected from investors in standard gold bullion (0.995 purity). An investor can buy and redeem the units either directly from the mutual fund or from the stock exchange. Gold ETFs allow investment in gold in small denominations which makes it easier for the retail investor to participate (Abraham S, 2007). Gold ETFs are based on two global models. One is the mutual fund Custodian Bank integrated model, where the gold is held in a Custodian Bank on behalf of the mutual funds. The other is the mutual fund warehouse receipt model where the custodian holds the warehouse receipts. The first is a passive fund, as the gold remains with the bank, disallowing active trading.
Investors will only gain from price movements. In the second warehouse receipts can be actively traded among banks and mutual funds, giving a chance to participate in trading gains as well (Verma T, 2006).

**Fixed Maturity Plans/ Serial Schemes**

Fixed maturity plans are closed-end debt funds. As close-end funds, FMPs cannot accept any fresh investment once the NFO is over. A fixed maturity plan (FMP) invests exclusively in a pre-specified debt security. FMPs come with various maturities. The popular tenors are of one month, three months and a little over a year. On maturity the scheme would redeem the security and pay the investor (Sankaran.S, 2007). FMPs are similar to bank fixed deposits in features such as fixed tenor and indicative return. But they do not guarantee return as FD’s does. FMP attracts Dividend Distribution Tax (DDT) while F.D. is subject to income tax. Since DDT is lower than the income tax rate, FMP gives a higher post-tax return than F.D (Shah B, 2008).

FMPs charge very low expenses. As a result, the margins from managing these funds are either wafer-thin or non-existent. Owing to cost inefficiency, fund houses have innovated with Debt Interval Fund. These funds are also beneficial to investors. In a FMP, investors have to compulsorily redeem at the end of the tenure, pay the applicable taxes and look for another FMP to re-invest. In case of a debt interval fund, an investor need not redeem his entire investment after every interval but can roll in over (Mutual Fund Insight, 2007).

Current active FMPs have expense ratios ranging between 0.03% and 2.11%. The same for interval fund is 0.01% - 1.88%. Though the
difference is not very significant it matters, since it is a debt investment where every basis point counts (Mutual Fund Insight, 2009).

**Hedge Funds or Leveraged Funds**

Hedge funds are specialised instruments run by investment managers whose reputations are so good that investors give them a free hand to invest in the manner they deem fit. Hedge funds are not subject to registration requirements and operate with a high level of flexibility. High network and institutional investors who allocate some money to high risk, high return products and choose investments internationally tend to go for hedge funds (Gajra R, 2006). A feature of hedge funds is the extreme risk they take in the market including shorting. Many hedge funds are leveraged funds where the fund manager invests a mix of funds belonging to its investors (unit capital and reserves) and funds from lenders (borrowed funds).

Hedge funds are, therefore, extremely risky funds; the level of risk being a function of the extent of leveraging. They are also less regulated across the globe. Thus far, by limiting the scope for borrowing by mutual funds, the Indian regulatory framework has kept out hedge funds.

**Option Income**

A typical option income fund will earn option premium through writing options on securities where the holding income is attractive enough to retain the security as a dead asset. The underlying view of the fund is that holding income plus option premium more than covers for the opportunity loss (Sankaran.S, 2007).
4) Types of Schemes by Geography

Country or Region Funds

Country Funds invest in securities from a specific country or region. The underlying belief is that the chosen country or region is expected to demonstrate superior performance which, in turn, would be favourable for the securities (Equity or Debt) of that country. The returns on country funds are affected not only by the performance of the market where they are invested, but also by changes in Exchange Rates.

Offshore Funds

Offshore funds mobilise monies from investors for investment outside their country. Indian mutual funds have been permitted to invest in foreign debt securities in countries with fully convertible currencies. The debt instruments, short term or long term, would need to have the highest rating (foreign currency credit rating) by their accredited/registered credit rating agencies.

Indian mutual funds may also invest in the units/securities issued by overseas mutual funds or unit trusts which invest in the aforesaid securities or are rated as mentioned above and are registered with overseas regulators (Sankaran.S, 2007).

5) Fund of Funds Schemes

Fund of funds schemes invest primarily in other schemes of the same mutual fund or other mutual funds. They are subject to the following investment restrictions:

i) They shall not invest in any other fund of funds scheme.
ii) They shall not invest their assets other than in schemes of mutual funds, except to the extent of funds required for meeting the liquidity requirements for the purpose of repurchases or redemptions, as disclosed in the offer documents of the fund of funds scheme (Sankaran.S, 2007). They are considered to be expensive when compared to any other equity diversified scheme. The reason being the higher expenses associated with them because in addition to the expenses of the Fund of Funds, all funds in which they invest have an associated expense. These funds have a limited down side and are a good option for conservative investors (Mutual Fund Insight, 2008).

2.1.7 Limitations of Indian Mutual Fund

(a) Indian mutual funds are externally managed. They do not have employees of their own. Also there is no specific law to supervise the Indian mutual funds. There are multiple regulations. While UTI is governed by its own regulations, the banks are supervised by Reserve Bank of India, the Central government and Insurance company mutual funds are regulated by Central Government. 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 (Amfi, 2006).

(b) At present the investors in India prefer to invest in mutual fund as a substitute of fixed deposits in Banks. About 75 percent of the investors are not willing to invest in mutual funds unless there was
a promise of minimum return (Outlook Money 2004).

(c) Sponsorship of mutual funds has a bearing on the integrity and efficiency of fund management which is vital in establishing investors' confidence. So far, only public sector sponsorship or ownership of mutual fund organizations had taken care of this need.

(d) Unrestrained fund rising by schemes without adequate supply of scrip can create severe imbalance in the market and exacerbate the distortions.

(e) Many small companies did very well in recent past, but mutual funds can not reap their benefits because they are not allowed to invest in smaller companies. Not only this, a mutual fund is allowed to hold only a fixed maximum percentage of shares in a particular industry. (Outlook Money 2005)

(f) The mutual funds in India are formed as trusts. As there is no distinction made between sponsors, trustees and fund managers, the trustees play the role of fund managers.

(g) The increase in the number of mutual funds and the various schemes has increased competition. Hence it has been remarked by senior broker "mutual funds are too busy trying to race against each other". As a result they lose their stabilizing factor in the market (www.nlfa.com).

(h) While UTI publishes details of accounts of their investments but mutual funds have not published any Profit and Loss Account and Balance Sheet even after its operation. (Outlook Money 2004)
(i) The mutual fund have eroded the financial clout of institution in the stock market for which cross transaction between mutual funds and financial institutions are not only allowing speculators to manipulate price but also providing cash leading to the distortion of balanced growth of market. (Amfi, 2000)

(j) As the mutual fund is very poor in standard of efficiency in investors’ service: such as despatch of certificates, repurchase and attending to inquiries lead to the deterioration of interest of the investors towards mutual fund.

(k) Transparency is another area in mutual fund which was neglected till recently. Investors have right to know and asset management companies have an obligation to inform where and how his money has been deployed. But investors are deprived of getting the information (Parekh Deepak, 2000).

2.1.8 Organizational Structure & Constituents of Mutual Fund

Mutual funds, are usually formed as trusts, three parties are generally involved viz.

(a) Settler of the trust or the sponsoring organization.

(b) The trust formed under the Indian Trust Act, 1882 or the trust company registered under the Indian Companies Act, 1956.

(c) Fund managers or the merchant banking unit.

(d) Custodians.

While in the USA and other countries an "arms length" distance is maintained between settlers, trustees and fund managers, whereas in
India, very often, there is an overlapping of roles. For example in the case of Canbank mutual fund, Canara Bank is the settler or sponsor, members of Canara Bank's board form the trust company as trustees and the subsidiary of Canara Bank, Canbank Financial Services Ltd. serves as fund managers.

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 (Sadhak.H, 2003).

A typical mutual fund organization structure in India can be graphically represented as follows:
Figure 2.1 Mutual Fund Organization Structure

(Source: Mutual Funds Products and Services: IIBF, 2007)
Figure-2.2 Typical Mutual Fund Organization Structure
Sadhak H. has represented a typical mutual fund structure (Fig-2.2) as above.

The variegated structure of mutual funds, thus, can appeal to the security motivation and other such aspects of savers, and attracts more savings by the creation of an array of financial assets. In developing countries, in particular, savings are institution-elastic. The volume of savings as well as its direction is considerably influenced by the structure of mutual funds (Sadhak H, 2007).

**2.1.8.1 Mutual Fund-Trust**

The instrument of trust must be in the form of a deed between the sponsor and the trustees of the mutual fund duly registered under the provisions of the Indian Registration Act, 1908. The trust deed should contain, in addition to the clauses prescribed by the SEBI, such other clauses that are necessary for safeguarding the interests of the unit holders. However, no trust deed should contain clause(s) that has the effect of (i) limiting/extinguishing the obligations/liabilities of the trust in relation to any mutual fund/unit holder or,(ii) indemnifying the trustees/asset management company for loss/damage caused to the unit-holders by their acts of negligence/commission/omission.

The main functions of Mutual Fund Trust are as follows:

(a) Planning and formulating mutual fund schemes.

(b) Seeking SEBI’s approval and authorization to these schemes.

(c) Marketing the schemes for public subscription.

(d) Seeking RBI approval in case NRIs’ subscription to mutual fund is invited.
(e) Attending to trusteeship functions. This function as per guidelines can be assigned to separately established trust companies too.

In a mutual fund trust, subscription made by the investor to the scheme, investments made by the mutual fund of the moneys received into capital market or money market instruments, the income received from such investments after incurring expenses incurred by the trust and any other assets bought by the mutual fund out of the investors moneys are trust property and the investors are entitled to all these properties as per the terms of the scheme and the provisions of the trust deed (Amfi, 2006).

Indian mutual fund is required to have an independent Board of Trustees who are not associated with the sponsors in any manner whatsoever. An AMC or any of its officers or employees is not eligible to act as a trustee of any mutual fund. In case a company is appointed as a trustee then its directors can act as trustees of any other trust provided that the object of such other trust is not in conflict with the object of the mutual fund. Additionally, no person who is appointed as a trustee of a mutual fund can be appointed as a trustee of any other mutual fund unless he is an independent trustee and prior approval of the mutual fund of which he is trustee has been obtained for such an appointment.

The trustees are responsible for ensuring that the AMC has all its systems in place, all key personnel, auditors, registrars etc have been appointed prior to the launch of any scheme. It is also the responsibility of the trustees to ensure that the AMC does not act in a manner that is favorable to its associates such that it has a detrimental impact on the unit holders, or that the management of one scheme by the AMC does not compromise the management of another scheme. The trustees are also required to ensure that an AMC has been diligent in empanelling and monitoring any
securities transactions with brokers, so as to avoid, any undue concentration of business with any broker. The Mutual Fund Regulations further mandates that the trustees should prevent any conflicts of interest between the AMC and the unit-holders in terms of deployment of net worth.

The trustees are also responsible for ensuring that there is no change carried out in the fundamental attributes of any scheme or the trust or fees and expenses payable or any other charge that would modify the scheme and affect the interest of unit holders, unless each unit holder is provided with written communication thereof. In addition, the unit holders must be given the option to exit at the prevailing Net Asset Value (NAV) without any exit load. They are obliged to perform a quarterly review of all transactions carried out between the mutual funds, AMC and its associates.

As far as professional indemnity cover for the trustees or the AMC is concerned, industry practice in India reveals that the insurance policy is taken out by an Indian Insurance Company (as is required by the Insurance Act, 1938) while the risk is subsequently ceded to an overseas re-insurer who underwrites the primary policy issued by the Indian insurance company (Amfi, 2006).

In the absence of trust companies, existing debenture trustees, banks and financial institutions may be contracted to act as mutual fund trustees with approval of SEBI. Alternatively, a separate Board of Trustees consisting of individuals of sufficient repute and experience may act as mutual fund trustees. In that event, at least 50% of the Board of Trustees shall be independent outside members. They shall not have any affiliation with the sponsoring institution or any of its subsidiaries. The trust
company, companies as aforesaid or the Board of trustees including the eligibility of each member shall be intimated to SEBI as per the guidelines. Trustees are required to submit a consolidated report six monthly to SEBI to ensure that the guidelines are fully being complied with. Trustees are also required to submit an annual report to the investors in the fund (Amfi 2006). The biggest problem with the trustee company model in India is that it is a part time relationship. Elsewhere in the world, they have professional trustee companies who do this more professionally. Here in India there is a trustee company with some independent Directors and not all are well versed in the mutual fund industry. The trustees' role is that of a sleeping partner and they find it difficult to raise issues. They are unable to play a proactive role (Sethu G, 2006).

2.1.8.2 Mutual Fund-Sponsor

The Sponsors of a mutual fund can be a public limited or private limited company registered under the Companies Act, 1956. One or more public and private limited companies can join to sponsor a mutual fund. The following are the requirements of a competent sponsor:

(a) The sponsor should have a good general reputation having directors with clean business records.

(b) The sponsor/any director/principal officer to be employed by the mutual fund should not have been guilty of any fraud/convicted of an offence involving moral turpitude/guilty of any economic offence.

(c) The sponsor company should have good credit record, default-free dealings with suppliers of material, good and tension-free personal relations and should not have any outstanding dues with bankers,
creditors and income-tax or sales tax authorities.

(d) The sponsor company should be able to contribute at least Rs.2 crore towards the paid-up capital of the Fund Managers or the Asset Management Company.

(e) The sponsor should contribute at least 40% to the net worth of the AMC. However, if any person holds 40% or more of the net worth of an AMC shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in the Mutual Fund Regulations.

(f) The sponsor is required, under the provisions of the Mutual Fund Regulations, to have a sound track record.

Regulation 7(a) Explanation, Securities and Exchange Board of India (Mutual Funds) Regulations, 1996:

"For the purposes of this clause ‘Sound track record’ shall mean the sponsor should:

(i) Be carrying on business in financial services for a period of not less than five years; and

(ii) The net worth is positive in all the immediately preceding five years; and

(iii) The net worth in the immediately preceding year is more than the capital contribution of the sponsor in the asset management company; and

(iv) The sponsor has profits after providing for depreciation, interest and tax in three out of the immediately preceding five years, including the fifth year" (Amfi, 2006).
In the establishment of mutual fund trust, the main role is played by the sponsors. Both the trustees and the fund managers or the AMC have to be located and appointed by the sponsor. Alternatively, the sponsor has to appoint Board of Trustees and incorporate an Asset Management Company. It has to submit to SEBI the drafts of the Trust Deed for creation of mutual fund trust with particulars of the persons consenting to be the Trustees both from the sponsor company and the outsiders. It has also to submit draft Memorandum and Articles of Association of Asset Management Company to SEBI with particulars of Directors i.e. the persons to be appointed from the sponsors’ Board and those to be taken from outside. It has also to suggest the name and particulars of the custodians to be engaged for the mutual fund. Once the mutual fund trust is authorized by SEBI, the role of sponsor diminishes as it is the Trust that will interact with SEBI (NCFM, 2003).

2.1.8.3 Mutual Fund-AMC

The sponsor or the trustees are required to appoint an Asset Management Company (AMC) to manage the assets of the mutual fund. Under the Mutual Fund Regulations, the applicant must satisfy certain eligibility criteria in order to qualify to register with SEBI as an AMC:

(a) The sponsor must have at least 40% stake in the AMC.

(b) The directors of the AMC should be persons having adequate professional experience in finance and financial services related field and not found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws;

(c) the AMC should have and must at all times maintain, a minimum net worth of Rs 100 million;
(d) the board of directors of such AMC has at least 50% directors, who are not associate of or associated in any manner with, the sponsor or any of its subsidiaries or the trustees;

(e) the Chairman of the AMC is not a trustee of any mutual fund

In addition to the above eligibility criteria and other ongoing compliance requirements laid down in the Mutual Fund Regulations, the AMC is required to observe the following restrictions in its normal course of business:

(a) Any director of the AMC cannot hold office of a director in another AMC unless such person is an independent director and the approval of the board of the AMC of which such person is a director, has been obtained.

(b) The AMC shall not act as a trustee of any mutual fund.

(c) The AMC cannot undertake any other business activities except activities in the nature of portfolio management services, management and advisory services to offshore funds, pension funds, provident funds, venture capital funds, management of insurance funds, financial consultancy and exchange of research on commercial basis if any of such activities are not in conflict with the activities of the mutual fund; However, the AMC may, itself or through its subsidiaries, undertake such activities if it satisfies the Board that the key personnel of the asset management company, the systems, back office, bank and securities accounts are segregated activity wise and there exist systems to prohibit access of inside information of various activities (Sadhak H, 2003).

(d) The AMC shall not invest in any of its schemes unless full disclo-
sure of its intention to invest has been made in the offer. However, an AMC shall not be entitled to charge any fees on its investment in that scheme.

The AMC is required to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme are not contrary to the provisions of the Mutual Fund Regulations and the trust deed. An AMC cannot, through any broker associated with the sponsor, purchase or sell securities, which is an average of 5% or more of the aggregate purchases and sale of securities made by the mutual fund in all its schemes. However, the aggregate purchase and sale of securities excludes the sale and distribution of units issued by the mutual fund and the limit of 5% shall apply only for a block of any three months (Sadhak H, 2003).

AMC has to discharge mainly three functions as given below:

(a) Taking investment decisions and making investments of the funds through market dealer/brokers in the secondary market securities or directly in the primary capital market or money market instruments;

(b) Realize fund position by taking account of all receivables and realizations, moving corporate actions involving declaration of dividends etc. to compensate investors for their investments in units; and

(c) Maintaining proper accounting and information for pricing the units and arriving at Net Assets Value (NAV), and the information about the listed schemes and the transactions of units in the secondary market. AMC has to feed back the trustees about its fund
management operations and has to maintain a perfect information system (NCFM, 2003).

2.1.8.4 Mutual Fund- Custodian

The mutual fund is required, under the Mutual Fund Regulations, to appoint a custodian to carry out the custodial services for the schemes of the fund. Only institutions with substantial organizational strength, service capability in terms of computerization and other infrastructure facilities are approved to act as custodians. The custodian must be totally de linked from the AMC and must be registered with SEBI. Under the Securities and Exchange Board of India (Custodian of Securities) Guide lines, 1996, any person proposing to carry on the business as a custodian of securities must register with the SEBI and is required to fulfill specified eligibility criteria. Additionally, a custodian in which the sponsor or its associates holds 50% or more of the voting rights of the share capital of the custodian or where 50% or more of the directors of the custodian represent the interest of the sponsor or its associates, cannot act as custodian for a mutual fund constituted by the same sponsor or any of its associate or subsidiary company (ICFAI, 2001).

Mutual Funds run by the subsidiaries of the nationalized banks had their respective sponsor banks as custodians like Canara Bank, State Bank of India, PNB etc. Foreign banks with higher degree of automation in handling the securities had assumed the role of custodians for mutual funds. Citibank has been a very prominent bank in this regard which acts as custodian for UTI and SBI's funds. With the establishment of Stock Holding Corporation of India, the work of custodian for mutual funds is now being handled by it for various mutual funds. A few other foreign banks are also eager to act as custodians as they are well equipped with a
network of telecommunication facilities and software support systems essential for efficient discharge of the role of the custodian. It is only because of this quality, the Indian Growth Fund (promoted by UTI Merrill Lynch) was shifted from SHCI to Citibank. Now SHCI is also fully equipped with the software support system and acts as custodian for mutual funds for SBI and other mutual fund schemes. Automation eliminates manual handling and reduces requisition and delivery time and brings efficiency in operations of a custodian. Besides, Industrial Investment Trust Company acts as sub-custodian for SHCI for domestic schemes of UTI, BOI MF and LIC MF etc (UTI, 2006).

The Securities and Exchange Board of India on 5th May, 1996, through its notification No.S.0.344 (E) has issued the SEBI (Custodian of Securities) Regulations, 1996. If any person wishes to act as custodian of securities on or after the regulations have come into vogue; he has to obtain a certificate to that effect from SEBI. The minimum capital requirement shall be a net worth of a minimum of Rs.50 crore. Generally, custodian services are availed of in-house by the mutual funds. However, the institutions which are acting as professional custodians are Stock Holding Corporation of India (SHCI), Citibank, Industrial Investment Trust Limited (IITL), Hong Kong Bank and BOI Shareholdings Limited. SHCI has not so far decided to extend their services as custodian to private sector mutual funds. The capacity of IITL is not specified to cater the needs of private sector mutual funds, only Citibank and Hong Kong Bank are in the limelight which could be contacted by the aspirant mutual fund sponsors. Responsibilities to be discharged by the custodians on behalf of mutual funds include receipt and delivery of securities, holding of securities, collecting income, holding and processing cost, corporate actions etc (BFSI@Kolkata 2007).
Functions of custodians widely cover safe keeping of securities, bid settlements, corporate actions and transfer agents. Salient features of each of these functions are given below:

(a) Safe keeping of securities covers a wider range of services rendered to the customer viz. scheme-wise segregation of assets and regular checking and verification of securities, registration of securities for proper verification, regular reconciliation of assets to accounting records (Sadhak H, 2006).

(b) Trade transactions take place at the instance of fund managers, but settlement are done at the instance of the custodian which is responsible for the timely receipt and delivery of cash and securities i.e. securities will be delivered on receipt of cash and payment will be made only on receipt of securities .Any discrepancies arising out of the trade settlements are resolved at the end of the custodian.

(c) Custodian also assists the corporate actions viz. dividend declarations, exercise the rights of equity holders, collection of dividends, rights, etc.

(d) There are four important functions which are attended to by the custodians in addition to the above viz. firstly, attending to shareholders transactional activities viz. to issue, transfer, exchange, redeem, maintain detailed records of transactions, receipt of dividends, reimbursement of dividend and purchase of securities, etc. Secondly, maintaining records of confirmations of transactions, cheque registers, certificates, files, commission reports, tax reporting etc (Sadhak H, 2006).
To sum up, the consolidated activities of sponsors, trustees, AMC and custodians form the basis of the organization and management of the mutual fund.

2.1.9 Mutual Fund in India

2.1.9.1 Evolution of Mutual Fund in India

The economic development model adopted by India in the post-independence era has been characterized by mixed economy with the public sector playing a dominating role. The industrial policy resolution was introduced by the government of India in the 1948, immediately after the independence. This outlined the approach to industrial growth and development.

Much latter in 1954, the committee on finance for the private sector recommended mobilization of savings of the middle class investors through unit trusts. Finally in July 1964, the concept took root in India when Unit Trust of India was set up with the twin objective of mobilizing household savings and investing the funds in the capital market for industrial growth. It was felt that UTI could be an effective vehicle for channelising progressively larger shares of household savings to productive investments in the corporate sector (Sadhak H, 2003).

Thus in India, the setting up of Unit Trust of India in 1964 marked the advent of mutual fund industry. UTI was set up by an Act of Parliament. Detailed debate had taken place in the parliament before this institution saw the light of the day. The basic objective of establishing the UTI was to mobilize the savings of the small Indian investors. In fact investment in the securities market for a person who is not well versed in the operations of the money and the equity markets is not easy. An institution which is
not financially strong and accepted to general public cannot hope to succeed or make any major contribution to our economic growth and progress. Of course there is a desire on the part of the people that the savings of the community must be controlled by the state and not by the individuals.

UTI was regulated since its inception by the UTI Act, 1963 and regulations framed there under. The initial capital of UTI was fixed at Rs 5 crore, contributed by the RBI Rs 2.50 crore, The LIC Rs 0.75 crore, the SBI and its subsidiaries Rs 0.75 crore, the Banks and the financial institutions Rs. 1.00 crore. UTI was established as a corporate body. The general superintendence, direction and management of the affairs and business of this corporate body vested in a board of trustees. In matters involving public interest the Central Government and the Reserve Bank of India had powers to give directions. The basic purpose of establishing the UTI was to give a fillip to equity market (UTI, Bombay, 1995).

During the years 1963-1987, UTI consolidated its position by offering a variety of products and extended its reach throughout the country but the growth of this industry in India was very slow till the end of 1980s, primarily because the objectives of development were geared towards mobilizing of domestic savings till 1986-87 under the control and supervision solely by UTI with a view to encouraging savings and investment and participation in the income, profits and gains accruing to the corporations from the acquisitions, holding, management and disposal of securities (UTI, Bombay, 1995).

The process of economic liberalization in the eighties not only brought in dramatic changes in the environment for Indian industries, corporate sector and the capital market but also led to the emergence of demand for
newer financial services such as issue management, corporate counseling, capital restructuring and loan syndication (Sadhak H, 2003).

Gradually, we noticed the arrival of mutual funds sponsored by public sector banks and financial institutions. In 1986 public sector banks and financial institutions were given permission to establish mutual funds. State Bank of India established the first mutual fund. SBI preferred to adopt the trust route and set up the mutual fund as a trust under the Indian Trusts Act, 1982. This choice was purely accidental (AMFI, 2006).

The period 1986-1993 can be termed as the period of public sector mutual funds (PMFs). From one player in 1985 the number increased to 8 in 1993. The party did not last long. When the private sector made its debut in 1993-94, the stock market was booming. The opening up of the asset management business to private sector in 1993 saw international players like Morgan Stanley, Jardine Fleming, J.P. Morgan, George Soros and Capital International along with the host of domestic players joined the party. But for the equity funds, the period of 1994-96 was one of the worst in the history of Indian Mutual Funds. (Sindhwani Sanjay, 2000).

After 1995, US-64 scheme encountered a serious crisis. In September, 1998 it was announced that the reserves of US-64 had turned negative. In October 1998 the UTI had appointed Deepak Parekh Committee to undertake a comprehensive review of the overall functioning of US-64, to revive US-64 scheme. UTI implemented almost all recommendations of the High Level Expert (Deepak Parekh) Committee Report, 1999 to reoccupy UTI's premier position in Indian financial system and to play the assigned role of mobilization of small savings and their profitable channelization for corporate industrial financing.
After two decades of UTI monopoly, some other public sector organizations like LIC (1989), GIC (1991), Can Bank (1987), Indian Bank (1990), Bank of India (1990), Punjab National Bank(1990) set up mutual funds. Thus until 1987 the UTI (Unit Trust of India) was the sole mutual fund/unit trust in the country. In the post—1992 period, mutual funds sponsored by other public and private sector financial institutions, corporates in collaboration with foreign investment and fund managers and foreign institutional investors emerged on the scene. In fact, private sector mutual funds commenced operations in the year 1993& 94 (Sadhak H, 2003).

On 31st August, 2002, the Cabinet Committee on Economic Affairs (CCEA) of India cleared a UTI bailout package for Rs.14561 crore. UTI had to split into two viz. Sick (UTI-I) and healthy (UTI-II) segments. CCEA's decision on 31.8.2002 regarding privatization of UTI's NAV-based schemes came as a shot in the arm for the government's disinvestment department. Since May, 2003 Unit-64 scheme had been terminated. The Government of India had to bear all the liabilities arising out of UTI-I and provided necessary funds to meet any shortfalls arising out of the assured returns promised by UTI to investors. As a result, the pressure on UTI to enter into distress selling was considerably eased (Financial Express, 2003).

In the Union Budget, 2005-2006, the Finance Minister in his speech believed that India was in a position to introduce "Gold Units" and create a market for such units. The Finance Minister in his speech proposed to ask SEBI to permit, in consultation with RBI, mutual funds to introduce Gold Exchange Traded Funds (GETFS) with gold as the underlying asset, in order to enable any household to buy and sell gold in units for as little
as Rs.100/- . Such units could be traded in the same manner as units of mutual funds. (Source: Economic Times, Tuesday March 01, 2005).

Recently, State Bank of India mutual funds has launched on 30.06.05 'Magnum COMMA fund'—a first of its kind open-ended equity scheme investing in the stocks of commodity based companies. Commodity based companies include a wide spectrum of companies engaged in Oil (Petrochemicals, Power and Gas), Metals (Zinc, Copper, Aluminum, Bullion, Silver), Materials (Paper, Jute, Cement) and Agriculture (Sugar, Edible Oil, Soya, Tea, Fertilizers) and in debt and money market instruments. COMMA is an acronym for Commodities in Oil, Metals, Materials and Agriculture. Commodities follow the basic economic principle of demand and supply. When demand exceeds supply due to capacity constraints, price move up and profit surge, providing with an enormous opportunity (BFSI @ Kolkata, 2008). Mutual Funds have played an important role in the development of the Indian capital market. Growing investor interest in the equity market over the years could also be gauged from the resource mobilization by mutual funds in India. Net funds mobilized by the Indian mutual fund industry (net of redemptions) increased sharply to Rs 93,985 crore during 2006-07 as compared with Rs. 52,780 crore during 2005-06 mainly due to resources mobilized under debt oriented schemes which almost quadrupled during the year. The net mobilization of resources by mutual funds under equity oriented schemes during 2006-07 declined, reflecting the risk aversion tendency among investors particularly in view of the stock market touching record peaks (RBI Bulletin, 2007) (Table-2.1)
Table 2.1: Funds Mobilized by Mutual Funds- Type of Schemes

<table>
<thead>
<tr>
<th></th>
<th>2005-06 (Rs Crore)</th>
<th>2006-07 (Rs Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Income /Debt Oriented Schemes</td>
<td>325</td>
<td>10,08,129</td>
</tr>
<tr>
<td>(i) Liquid/ Money Market</td>
<td>45</td>
<td>8,36,859</td>
</tr>
<tr>
<td>(ii) Gilt</td>
<td>29</td>
<td>2,479</td>
</tr>
<tr>
<td>(iii) Debt (other than assured return)</td>
<td>251</td>
<td>1,68,791</td>
</tr>
<tr>
<td>B. Growth /Equity Oriented Schemes</td>
<td>231</td>
<td>86,014</td>
</tr>
<tr>
<td>(i) ELSS</td>
<td>37</td>
<td>3,935</td>
</tr>
<tr>
<td>(ii) Others</td>
<td>194</td>
<td>82,079</td>
</tr>
<tr>
<td>C. Balanced Schemes</td>
<td>36</td>
<td>4,006</td>
</tr>
<tr>
<td>D. Fund of Funds Schemes</td>
<td>13</td>
<td>845</td>
</tr>
<tr>
<td>Total</td>
<td>592</td>
<td>10,98,149</td>
</tr>
</tbody>
</table>

* As at the end of March ELSS: Equity Linked Savings Scheme Source: Securities Exchange Board of India
The Great Panic of 2008 and Mutual Fund:

There are three main parts of the crisis: (i) the Credit Crunch, (ii) the Economic Slowdown and (iii) the Stock Market Crash. These three are obviously interrelated.

(i) The Credit Crunch:

Debt of all kind had become hard to raise. It is not just about big – ticket, long – term lending but routine stuff like working capital and suppliers’ credit. Over the past months of mid-2008 the credit markets had seized up not just in U. S. and Europe but also in the rest of the world, including India. This credit squeeze was a bigger problem because the past five years had been a period of easy and cheap money. Companies had created their entire business model around the continued availability of easy credit. Suddenly, almost overnight, this credit vanished.

Banks had severely limited fresh loans. Not only were fresh loans not provided, but banks were also avoiding actual disbursal of loans that had already been approved.

Over the latter part of 2008, the standard explanation for this drying up of money had been that lenders no longer trusted borrowers.

(ii) The Economic Slowdown:

On Friday, October 10, 2008 India’s Index of Industrial Production (IIP) gave a deep shock to the market. The IIP for August was announced and it was down to just 1.3% from 10.7%. The industrial production in 2007 was 10.9% more than that in August 2006, but August 2008 was just 1.3% higher than August 2007. There were plenty of other indicators that indicated that the economic growth was slowing down.

It must be noted that before the current crisis took hold, the Indian authorities seemed to have made a clear choice that low growth was a lesser evil than a high inflation. For a few months the RBI has been raising interest rates and squeezing money out of the economy. This was
believed to limit inflation but hinder growth. The crisis seems to have induced a reversal of that thinking. What helped reverse the anti-growth policy was the receding fear of inflation getting worse. The prices of oil and other commodities were the main drivers of high inflation in early 2008. These were in full retreat towards the end of 2008. Some economists are talking about a far more severe scenario in which the world goes into a severe reversal for many years.

(iii) The Stock Market Crash:
The stock markets were in a pure panic phase. After that, there was a phase where prices drifted along at a lower level for some time. Markets oscillated between over-reaction on the positive side and over-reaction on the negative side. Human behaviour being what it is the negative over-reaction is faster than the positive one. The credit squeeze made the crash more severe (Mutual Fund Insight, Oct, 2008).

On January 8, 2008, the Sensex closed at 20,873.33. Investors were ecstatic at this new high. But it was not long before investors began to feel the jitters. On February 7, the Sensex fell by 613 points over the previous day’s close and on February 11, the fall was by 834 points. On July 15, it closed at 12,676.19, which translated into a 654 points fall over the previous day close. Within six months (January 8 – July 15, 2008), the Sensex experienced a fall of 8,197 points.

The reasons for such a fall were many. Ridiculously high valuations, which automatically made a market vulnerable to a correction, skyrocketing price of crude oil, rising commodity prices, inflation, higher interest rates, global growth concerns and political uncertainty. There were pockets of deep pain (Table: And They All Tumbled Down) with pharma and info tech stocks getting away the least bruised.
The mutual fund schemes which were focused on real estate, construction, power, capital goods and banking were the ones that tumbled. Another common thread running through all funds that were the hardest hit during this period was the high allocation of mid – and small – cap stock, the least being 43% and the highest being 99%.
Thematic funds are quite explosive. The extra upside potential that they offer can well be offset by the risk that they assume. The pronounced losses that they incur during downturns can nullify the fabulous gains during ’rallies. And it was basically such funds that got hit the hardest, with the exception of two tax saving funds (Mutual Fund Insight, Aug 2008).

Table 2.3: The Infamous Dozen

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Jan 8 – Jul 15,’08</th>
<th>Q4’07</th>
<th>2007*</th>
</tr>
</thead>
<tbody>
<tr>
<td>JM HI FI</td>
<td>-58.18</td>
<td>34.29</td>
<td>67.17</td>
</tr>
<tr>
<td>ABN AMRO Tax Advantage Plan</td>
<td>-53.49</td>
<td>31.76</td>
<td>56.31</td>
</tr>
<tr>
<td>Taurus INFRA- TIPS</td>
<td>-52.23</td>
<td>32.82</td>
<td>-</td>
</tr>
<tr>
<td>Kotak Emerging Equity</td>
<td>-52.04</td>
<td>36.93</td>
<td>-</td>
</tr>
<tr>
<td>ABN AMRO Future Leaders</td>
<td>-51.92</td>
<td>25.97</td>
<td>47.59</td>
</tr>
<tr>
<td>JM Equity Tax Saver Fund Series 1</td>
<td>-51.62</td>
<td>22.08</td>
<td>-</td>
</tr>
<tr>
<td>Principal Junior Cap</td>
<td>-51.11</td>
<td>33.63</td>
<td>67.27</td>
</tr>
<tr>
<td>Magnum Emerging Business</td>
<td>-51.07</td>
<td>32.39</td>
<td>64.46</td>
</tr>
<tr>
<td>JM Small &amp; Mid – Cap Reg</td>
<td>-50.87</td>
<td>42.06</td>
<td>-</td>
</tr>
<tr>
<td>JM Emerging Leaders</td>
<td>-50.77</td>
<td>41.65</td>
<td>94.51</td>
</tr>
<tr>
<td>LICMF India Vision</td>
<td>-50.63</td>
<td>38.18</td>
<td>-</td>
</tr>
<tr>
<td>JM Basic</td>
<td>-50.61</td>
<td>33.04</td>
<td>111.44</td>
</tr>
</tbody>
</table>

*Calendar Year

(Source: Mutual Fund Insight, Aug 2008)

**Mutual Fund and Satyam debacle:**

In November 2008, the two fund houses with the largest number of Satyam Shares were UTI Mutual Fund and HDFC MF. By December the HDFC MF increased the number from 51 lakh (November) to 106
lakh (December). Sundaram BNP Paribas MF had just 4.8 lakh shares in November and erred grievously by increasing its holdings to a colossal 58 lakh shares, which translates into a ridiculous 1,222% hike.

When one looks at the 10 schemes with the maximum number of Satyam shares, four from HDFC MF and three from Sundaram BNP Paribas MF featured in the list. What was astounding was that four schemes, including Sundaram BNP Paribas Tax saver and HDFC Prudence, did not have any exposure to the Satyam stocks in November. They actually entered the stock in December (Mutual Fund Insight, Jan 2009).

2.1.9.2 Regulatory Framework of Mutual Fund

The regulation of mutual funds operating in India falls under the purview of the authority of the Securities and Exchange Board of India (SEBI). Any person proposing to set up a mutual fund in India is required, under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 to be registered with SEBI (Amfi, 2006).

The mutual fund regulations lay down several criteria that need to be fulfilled in order to be granted registration as a mutual fund. Every mutual fund must be registered with SEBI and must be constituted in the form of a trust in accordance with the provisions of the Indian Trusts Act, 1882. The registration of mutual funds with the SEBI is subject to certain terms and conditions, namely

(a) Trustee/sponsor/asset management company/custodian would have to comply with the SEBI regulations.

(b) The mutual fund would immediately/forthwith inform the SEBI if any information/particulars previously submitted were misleading/false in any material respect as also of any material change in the
information/particulars previously furnished, which have a bearing on the registration granted by it.

(c) Payment of necessary registration fee. Mutual funds are also required to pay an annual service fee (Amfi, 2006).

2.1.9.3 Options and Plans of Mutual Fund

- **Systematic Investment Plan (SIP)**
  Systematic Investment Plan (SIP) - Under this facility an investor can invest a certain amount every month for a pre-decided period of time usually six months or one year through post-dated cheques at applicable NAV-related prices. This facility helps the investors to average out their cost of investments over a period of six months or one year and thus overcome the short-term fluctuations in the market. This strategy is popularly known as Dollar-cost averaging. Dollar-cost averaging can help limit the down side of a worst-case scenario of an immediate drop in asset value after a certain sum is invested. Market research has shown that such drop-offs are relatively rare compared to the strong emphasis the strategy puts on avoiding them (Chowdhury A, 2008).

SIP does not necessarily entail putting in uniform amounts in a scheme each month and should depend on the extent to which the NAV of the asset is volatile. When NAV falls, more money should be put in to pick up a larger number of units. When NAV goes up smaller amount should be invested. SIP is effective only if the product is investment worthy and a fall in the NAV is driven more by external factors that are temporary in nature- like poor market sentiments etc. (Shashikant Uma, 2005).
• **Systematic Withdrawal Plan (SWP)**
In this plan the investor withdraws fixed amount of money periodically. SWP is a mirror image of SIP.

• **Systematic Transfer Plan (STP)**
Through a STP, the investor can transfer parts of a lump sum from one MF scheme to another, within the same fund house, at regular intervals. The investor can first park his funds in a liquid or floating rate debt fund, and then get it transferred to the scheme (usually equity or balanced) of his choice at regular intervals. The STP route will help the investor average the cost of acquisition of units. In effect, a STP follows the same approach as a SIP. The major difference between the two is that STP works better for lump sum investments. The money parked in liquid or floating rate funds earn a higher return than in a simple savings account. STP provides the flexibility of reviewing the amount to be transferred and the intervals at which the transfer takes place (Kohli S, 2007).

**Switch Facility**

A switch is a single transaction that combines a redemption and purchase transaction into one. An inter scheme switch is done between specified schemes of a fund house. An intra scheme switch is done between options of a scheme. A switch can be done by putting in a request specifying the details of the schemes and the number of units to be redeemed, and the scheme to be invested into. The mutual fund gives effect to the redemption and purchase simultaneously (Abraham S, 2008).
• **Gift Facility**

The unit holders can write to the AMC/Registrar requesting for the gift form to gift the units (by way of transfer of units to the donee), to the extent provided in the Regulations (HB&F, 2007).

• **Dividend, Growth, and Dividend Re-investment Plans**

Among the investors who subscribe to a scheme’s investment philosophy, some might prefer a regular flow of income (dividend option), while others might prefer their income from the scheme to grow in the scheme itself (growth option). Some may like the amount to be declared as a dividend, but re-invested in the same scheme (dividend re-investment option).

To the extent that the investor has been paid out a dividend, her investment in the scheme would be worth less than an investor who has let her dividend grow in the scheme. Similarly, the new unit issued in a dividend re-investment option will bring down the per unit value (Sankaran S, 2007).

Investor should opt for an option that minimizes their tax liability. If dividend income is tax free (as is the case with dividend with the equity funds) then the dividend option or the dividend re-investment option is a good bet. If capital gains are tax free (as is the case currently with equity-oriented funds) then choosing the growth option would probably be viable. If both are tax exempt, then the net returns from any of the above options would be identical (Mutual Fund Insight).

2.1.9.4 **Minimum Number of Investors**

Every new scheme and individual plan under the schemes needs to fulfill both of the following conditions:
• Have a minimum of 20 investors; and
• No single investor should account for more than 25% of the corpus of such scheme/plan(s).

New open-end schemes can fulfill the above requirements within three months or the end of the succeeding calendar quarter, whichever is earlier, from the close of the New Fund Offering (NFO), failing which the scheme would have to be compulsorily wound up.

The three month balancing period is not applicable to fixed maturity plans and closed end schemes. Such schemes, therefore, need to comply with both requirements at the very time of allotment.

The guideline regarding the number of investors is not applicable to exchange traded funds (Sankaran S, 2007).

2.1.9.5 Net Asset Value (NAV)

• In order to calculate the NAV of a scheme, each asset and liability of the scheme needs to be valued:

\[
\text{NAV} = \text{Value of all assets} - \text{Value of liabilities other than unit holders.}
\]

• Conservative and Aggressive NAV

**Conservative NAV** translated into operational terms would under-value investments and over-provide for expenses. Accountants’ often prefer a conservative NAV.

If the monies that an investor would recover on selling the units are determined by this conservative NAV then an exiting investor will recover lesser than what is really due.

The reverse is an **Aggressive NAV** where investments are over valued and expenses are under provided. Thus, it would penalize new investors, while benefiting exiting investors.
Some fund houses get NAV calculated through independent entities like banks (Kohli, S, 2008)

- **Historic and Forward NAV**

  NAV is impacted by changes in both liability and assets sides of schemes. The general practice is to look at both liabilities and assets on day-end basis. If the sale and re-purchase of units are affected on the basis of previous day's NAV then it is called **Historical NAV Basis**.

  An alternative for the mutual funds is to affect sale and re-purchase of units on the basis of the next succeeding NAV (**Forward NAV Basis**). Mutual fund schemes mostly transact on the basis of Forward NAV.

- **Real-time NAV**

  A few mutual funds have put in place systems where by the asset side of the scheme can be marked to market on real time basis. This entails capture of information on sales and purchases of securities on an ongoing basis and weighting this with market feeds on current values of the securities (Sankaran S, 2007).

- **IPO and NAV**

  There is no NAV during an IPO (Initial public offer): The funds are deployed by the treasury on a short-term basis. It is only when the IPO closes and units are allotted that the scheme account comes into existence. It is after that the investments are made (Nayak Shilpa, 2004).

  **2.1.9.6 Load**

  **Entry Load**

  An AMC may decide that investors should pay more than NAV for their investments in each unit of the scheme. The incremental amount paid by new investors is called “entry load” or “front end load”.

  Sale Price = NAV + Entry Load.

  The entry load would be retained in separate account from which the AMC would meet part of its selling and distribution expenses. Generally,
debt schemes do not charge an entry load.

**Exit Load**

An AMC may decide that sellers would recover less than NAV for the units they sell in a scheme. This shortfall, borne by existing investors is called the “exit load” or “back end load”. The exit load would go into a separate account from where the AMC would meet part of its selling and distribution expenses.

Re-purchase price = NAV - Exit Load

**Contingent Deferred Sales Charge (CDSC)**

AMC’s often choose to reward investors who stay with them longer. This is achieved through a Contingent Deferred Sales Charge, where the longer an investor holds on to ones units the lower the CDSC one bears.

**Load Funds and No Load Funds**

AMC’s may launch schemes either on a “load” basis or on “no-load” basis or on a mixed basis (one class of units on load basis, the other class without load). There is no bar on a no-load scheme charging ongoing sales expenses to the fund. In a no-load scheme entry and exit load is not chargeable. However, the AMC can levy a CDSL even in a no-load scheme (Sankaran S, 2007).

**2.1.9.7 Accessibility**

An interested investor in mutual fund units can purchase units through agents, brokers, and distributors or directly from the fund. Mutual fund units, incase of many funds, can also be bought on-line. A prospective investor can apply to a mutual fund through the offices or points of acceptance (PoA) of that particular mutual fund across the country or can access various on-line brokerages. On-line brokerages can work with three types of accounts: Internet trading account, demat account and Savings Bank account with a partner bank. An existing investor can
directly invest through mutual fund website (Shah B, 2008). In recent times few mutual funds have made it available through Automated Teller Machine (ATM). Mutual Fund products are also distributed through selected Post Offices (IIB&F, 2007).

2.1.9.8 Comparison with other products

Company Fixed Deposits vs. Mutual funds
Fixed deposits are unsecured borrowings by the company accepting the deposit. The monies of investors on a mutual fund scheme are invested by the AMC in specific investments under that scheme. On the other hand, there is no such direct correlation between a company’s fixed deposit mobilization, and the avenues where it deploys these resources. A corollary of such linkage between mobilization and investment is that the gains and losses from the mutual fund scheme entirely flow through to the investors. Therefore, there can be no certainty of yield. On the other hand the return under a fixed deposit is certain, subject only to the default risk of the borrower. Both fixed deposits and mutual funds offer liquidity, but subject to some differences:

1. The provider of liquidity in the case of fixed deposits is the borrowing company. In mutual funds, the liquidity provider is the scheme itself for open end schemes, or the market in case of close-end schemes.

2. The basic value at which the fixed deposits are encashable is not subject to market risk. However, the value at which units of a scheme are redeemed entirely depends on the market (Sankaran.S, 2007).
Bank Fixed Deposits vs. Mutual funds
Bank fixed deposits are similar to company fixed deposits. The major
difference is that banks are more stringently regulated than the
companies. They even operate under stricter requirements mandated by
RBI. While the above are causes for comfort, bank deposits too are
subject to default risk. Further, bank deposits up to Rs 1 lakh are
protected by the Deposit Insurance and Credit Guarantee Corporation
(DICGC) (Sankaran S, 2007).

Bonds and Debentures vs. Mutual funds
Bonds and debentures unlike fixed deposits are transferable securities.
While an investor may have an early encashment option from the issuer
(for instance through a “put” option), liquidity is generally through a
listing in the market. Implication of this is, if the security does not get
traded in the market, then the liquidity remains on paper. In this respect,
an open-end scheme offering continuous sale/re-purchase option is
superior. Debt securities could be backed by a hypothecation or mortgage
of identified fixed and /or current assets e.g. secured bonds or debentures.
In such a case, if there is a default, the identified assets become available
for meeting redemption requirements. An unsecured bond or debenture is
for all practical purposes like a fixed deposit, as far as access to assets is
concerned. The investments of a mutual fund scheme are held by a
custodian for the benefit of investors in the scheme. Thus securities that
relate to a scheme are ring fenced for the benefit of its investors.

Equity vs. Mutual funds
Investment in both equity and mutual fund is subject to market risk. An
investor holding an equity security that is not traded in the market place
has a problem in realizing value from it. But investment in an open-end
mutual fund eliminates this direct risk of not being able to sell the
investment in the market. An indirect risk remains because the scheme has to realize its investments to pay investors. Another benefit of equity mutual fund schemes is that they give the investors the benefit of portfolio diversification through a small investment (Sankaran.S, 2007).

**Life Insurance vs. Mutual funds**

Life insurance is a hedge against risk and not really an investment option. So, it would be wrong to compare life insurance against any other financial product (Sankaran.S, 2007).

Resume

With the emergence of the capital market at the centre stage of the financial system, from the marginal role a decade earlier, we witness during the same period, a significant institutional development in the form of a diversified structure of mutual funds. A mutual fund is a special type of investment institution that acts as an investment conduit. It pools the savings, particularly of the relatively small investors, and invests them in a well diversified portfolio of sound investment. Mutual funds issue securities (known as units) to the investors (known as unit holders) in accordance with the quantum of money invested by them. As an investment intermediary, they offer a variety of services/advantages to the relatively small investors who, on their own, cannot successfully construct and manage an investment portfolio mainly due to the small size of their funds, lack of expertise and experience and so on. These, include convenience, lower risk through diversification, expert management and reduced cost due to economies of scale. Mutual funds have a positive role to play with professional research aiding the portfolio planning and management. Mutual funds offer affordability with convenience of investing and the accompanied benefits of professional
research and portfolio management. One of the advantages of investing in mutual funds is that an investor does not have to pay attention to short-term market movements, which will be looked into by the fund manager. Mutual funds not only provide a support to the corporate sector, but also assist in the process of financial innovation.

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 channelise these savings to the capital markets, set up the Unit Trust of India (UTI). Unit Trust of India was set up on February 1, 1964 as a public sector monolithic mutual financial institution by the Government of India under the Unit Trust Act of India, 1963. The growth of Indian mutual fund industry was very slow till the end of 1980's. It played a pivotal role in corporate financing and securities market till the early 1990's. During the last three and a half decades the UTI has been a dominant player in the mutual fund industry. But with the liberalization of the Indian economy in the post 1991 phase, it had to face competition from the other financial institutions and mutual funds, and its role had substantially declined. The Indian mutual fund industry is dominated by the UTI. The second largest category of mutual funds are the ones floated by nationalized banks. The third largest category of mutual funds is the ones floated by the private sector and by foreign asset management companies. Mutual Fund of India is set up in the form of a trust, which has sponsor, trustees, Asset Management Company and a custodian. Reserve Bank of India set up a high-level enquiry committee known as the Janakiraman Committee (1991) to evaluate the objectives of mutual funds as well as to identify several types of irregularities in securities transactions which were used to siphon off funds out of the banking system. Mutual funds are now competing with commercial banks.
The traditional saving avenues are losing out in the current scenario. Mutual funds provide attractive investment choice to the investors offering various features of funds. One can say that the Indian mutual fund industry is moving from infancy to adolescence, the industry is maturing and the investors and funds are frankly and openly discussing difficulties, opportunities and compulsions.
2.2 Marketing Plan for a Mutual Fund

A marketing plan for mutual funds services needs to stress the firm-product-customer relationship.

2.2.1 Product Design and Range

The products (schemes) of mutual funds are basically investment oriented and the savings mobilized by them are invariably invested in the instruments (shares, debentures) projected in the schemes. As there is little scope for flexibility, due care needs to be taken while designing particular products. The expected changes in the capital-stock market need to be taken into account to determine the future investment return. The changing profile of customers (investors) must also be taken into account in order to identify the savings market.

Different segments of the potential savings market have different expectations- long-term growth, regular income tax benefits, and so on. New products must be aimed at satisfying one or more objectives. Tax laws and other related regulations also play an important role in the designing of a new product, because, it is within the existing framework of tax regulations that benefits can be offered to investors.

India lags behind countries like the US, the UK and Japan in terms of innovative products. The investor’s options are restricted due to the limited range of products. This has probably happened due to lack of experience and the risk-averse conservative attitude of the management of mutual funds.

Like product planning, product launching is a crucial element of marketing. Many Indian mutual funds have performed poorly because their launching has been wrongly timed. Market research can help to assess the needs of potential customers, availability of existing products and future growth in demand. Before formally launching a new product, test marketing can be conducted (Sadhak H, 2003).
2.2.2 Brand Policy

An important function of product development is the selection of the brand name and pricing of the product. The brand name highlights the market segments, inherent benefits and investment objectives, and should help ensure the customers’ loyalty.

Brand identity is an important factor in marketing because it facilitates product identification at the marketplace. In India most products are linked to the names of the mutual funds. However, there are others which are not, e.g., the ‘Dhan Series’ is identified with LIC Mutual Funds, the ‘Master Series’ with UTI and ‘Magnum’ with SBI Mutual Funds. It can be said that Indian mutual funds have been quite successful in brand policy and brand identification (Source: Sadhak H, 2003).

2.2.3 Pricing Policy

The price of mutual funds products is inextricably linked with returns. The SEBI (Mutual Funds) Regulations, 1996, contain guidelines on the pricing of units. As per this guideline, the schemes may also provide for the price at which the unit may be subscribed to buy and sold to the independent participants in the scheme, and the price at which they may, at any time, be repurchased by the mutual funds. Mutual funds are also to publish the sale and repurchase prices at least once a week. In addition, they are to ensure that the difference between the sale and repurchase price does not exceed 7% of the sale price.

The face value of the units of most mutual funds in India is Rs.10. However, before deciding on the price, the incentives, brokerage charges and commission are to be decided upon because the expenses towards these items will affect the ultimate returns to the investors (Source: Sadhak H, 2003).
2.2.4. Costs

According to the SEBI regulations, the AMC can charge the mutual funds with investment, management and advisory fees, which are fully disclosed in the prospectus.

An AMC can launch a 'load', 'no-load' or 'mixed scheme'. The latter type can have two classes of units - the one with load and the other without load. An AMC can also launch a 'partial load' scheme, in which a part of the load is borne by the AMC and the rest by the scheme. The initial issue expenses of a 'no-load' scheme shall be borne by the AMC. Load-basis open-ended schemes are to be amortized over a period not exceeding five years. The amortized portion of the expenses of schemes floated on a load basis will be included in the NAV calculation, but will not be included in the NAV for the calculation of the investment management and advisory fees of the AMC. An AMC can charge an additional management fee of up to 1% of the NAV. The AMC can also levy a contingent deferred sales charge for early redemption from the redemption proceeds - of up to 4% in the first year, 3% in the second year, 2% in the third year and 1% in the fourth year.

The concept of the no-load fund is gradually gaining ground in India. Some funds have moved towards low-load schemes (Source: Sadhak H, 2003).

2.2.5. Distribution and Promotion of Products

A new mutual fund product may have all the desired qualities, but this does not ensure its spontaneous acceptance by the customers. Its success would greatly depend on appropriate distribution and promotion. The identification of appropriate market segment of the product, and the selection of the appropriate distribution channels and promotional aids are essential.
The identification of the appropriate market segment is crucial for the promotion and distribution of the products. Market segment are identified on the basis of the nature of the product, direct and indirect benefits of the product, requirements of the customers, product usage rate, and so on.

Till the advent of public sector mutual funds (in 1987) and private sector mutual funds (in 1993), the marketing strategy followed by UTI was largely passive. UTI units have been sold mainly through LIC agents (like agents/brokers) in India, unlike in the US and Japan, under no obligation to follow any norms.

While Indian mutual funds still depend mostly on retailing, there has been a distinct change in the marketing strategy since 1993.

The major market intermediaries are: agents appointed by the respective mutual funds, stockbrokers who are members of the stock exchange and are registered with the mutual fund, and institutional and corporate agents.

Public sector mutual funds like LIC MF and UTI have an edge over the others due to their well-established agency network. Though the corporate offices formulate the overall marketing strategy and coordinate the activities relating to publicity and product distribution, local-level activities are supervised and coordinated by the zonal and branch offices.

In order to tap the savings potential in rural India, mutual funds are paying greater attention to rural marketing. UTI has taken specific steps to promote units in rural areas through the PURA (promotion of units in rural areas) scheme.

Investors can also buy units through direct subscription. However, the percentage of funds mobilized thus to the total funds mobilized under any scheme is very nominal. SEBI has directed all mutual funds to waive off the entry load on investments made directly into mutual funds and not through a distributor. It will mean a situation where an investor can now
remove his broker from the folio and make it under the ‘Direct’ mode. This would be especially beneficial for those who have on-going SIPs in mutual funds (purchased through distributors) and want no entry load deductions on future installments (Mutual Fund Insight, 2008). Product promotion in India has taken the usual routes of advertisement and publicity. Mutual funds advertisements are regulated by SEBI, which prohibits the publication of materials and contents that may mislead the investing public. Communication is important for effective marketing, and communication through advertisement is the most important promotional aid for a mutual fund. Once the target group and its requirements are identified, an appropriate advertisement strategy (through television, radio, financial/general newspapers, leaflets, etc.) is devised in order to reach the maximum number of potential customers. Advertising campaigns must aim at creating awareness of the product, its comparative advantages and future potential, past performance of similar products and superiority of the fund in relation to others in terms of assets, management and performance servicing (Source: Sadhak H, 2003). 2.2.6. Customer Service The marketing of services is significantly influenced by the quality of the services as well as the interpersonal relationship between the customer and the organization providing the services. Servicing plays a significant role in the mutual funds industry, as in any other, financial industry. It makes a distinct difference if the services, such as issuing certificates/cheques and attending to customers problems, are prompt. Since the rates of expected return are more or less the same for all the schemes, it is the quality of services which becomes the deciding factor. Services can be provided through external agencies, or internally through the services department. Most mutual funds in India provide after-sales
services, both through external agencies and an internal service department, although they largely rely on external agencies (Registrars and Transfer Agents) that are specialized in the job. There are occasional complains that the after-sales services are not up to the mark. This is probably due to shortage of staff. Apart from this, mutual funds in India need to develop in house expertise to render more prompt cost-effective after-sales services.

In order to ensure quality services to customers, service audit would be of great help as it would help monitor the range of services usually rendered by mutual funds. These services relate to sales, complaints and suggestions. Service standards can be fixed on the basis of the customers’ levels of expectation, which can be ascertained through market survey.

It must be remembered that the marketing is a dynamic process and aims not only at “sale” but at “resale” and an enduring relationship with customers (Source: Sadhak H, 2003).

### 2.2.7 Expense and Load Factor as a Marketing Strategy

Fund houses charge the investors an Asset Management Fee, as well as pass on other expenses incurred in running the fund. All these expenses are deducted from the investors NAV, within limits, reducing investors return to that extent. Exactly how much expense investor scheme charges an investor in a given year is stated in the annual report, in the ‘Notes to Accounts’. It is stated in the form of the ‘Expense Ratio’, which are costs as percentage of its corpus. So, in a given year, if the investors’ scheme returns 15% and shows an expense ratio of 2%, it means that it earned 17%, but used up 2% points of that to meet expenses. Obviously, the lower a scheme’s expense ratio, the better it is for the investor.

In order to ensure that mutual funds don’t overcharge the investors, SEBI lays down limits on the expenses a scheme can charge its unit holders. Annual expenses of equity funds are capped at 2.5% of their ‘average
weekly net assets' (52-week average of the scheme’s corpus). For debt funds the corresponding figure is 2.25%. Only actively managed equity funds veer towards the limits set by SEBI. Most other kind of funds stays well in. This variance has much to do with the nature of the schemes. Equity fund management is more expensive than debt fund management, and active management more expensive than passive fund management. Also competition has reduced expenses. For instance, pre-1996, schemes were charged 4% as annual fees!

Some expenses are inevitable. Every scheme has to employ fund managers and analysts, pay for buying and selling shares, run offices. On the investors’ part, investors need to ensure two things. One, investors’ scheme doesn’t charge investors more than it’s due, a fair measure of which is not the SEBI limit, but the industry average (Table-3.1). Two, the scheme delivers. Its all very well to choose an equity fund with an annual expense ratio of 2% over another whose expense ratio is 2.5%, but this edge gets blunted if the former, pays, return of 10% and the latter 20%.

### Table-2.4 Expense Limits

<table>
<thead>
<tr>
<th>Category</th>
<th>SEBI LIMIT (%)</th>
<th>INDUSTRY STANDARD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Funds</td>
<td>2.50</td>
<td>0.5-2.5</td>
</tr>
<tr>
<td>Index Funds</td>
<td>1.50*</td>
<td>0.5-2.0</td>
</tr>
<tr>
<td>Income Funds</td>
<td>2.25</td>
<td>0.5-2.25</td>
</tr>
<tr>
<td>Gilt Funds</td>
<td>2.25</td>
<td>0.5-1.8</td>
</tr>
<tr>
<td>Liquid Funds</td>
<td>2.25</td>
<td>0.2-1.0</td>
</tr>
</tbody>
</table>

(Figures represent a fund’s annual expenses as % of average net weekly assets)

(Source: Outlook Money, 2007)

* SEBI has decided to cap the maximum expenses that can be charged by an index fund to 1.5% of the AUMs. Previously the capping was 2.5%, in line with any other equity fund. The move is welcoming as management
of an index fund is far less tedious and effortless than any other actively managed equity fund (Mutual Fund Insight, 2007).

Most fund houses levy a nominal processing charge when investor enters or exits-sometimes on both occasions. This amount, termed as ‘load’, is charged as a percentage of NAV, and has the effect of reducing the investors return by that amount. When levied at the time of entry, it is termed as an ‘entry load’: on exit, an ‘exit load’. If investors earn 10% from investment scheme, they have to pay an exit load of 2%, thus investors effective returns get whittled down to 8%.

A fund can charge a maximum combined load (entry plus exit) of 7%. But the fund must also ensure that the stretch between the sale price and the redemption price after the loads are charged does not exceed 7%. However, most funds charge less-typically in the range of 0.5% to 2.5%. Schemes charging more than that are best avoided, simply because investors will find ample good and cheap options. Here too, competition has helped-most debt funds don’t levy a load.

<table>
<thead>
<tr>
<th>Table-2.5 Load</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Category</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>SEBI Limit</td>
</tr>
<tr>
<td>Diversified Equity Funds</td>
</tr>
<tr>
<td>Index Funds</td>
</tr>
<tr>
<td>ELSS</td>
</tr>
<tr>
<td>Income Funds</td>
</tr>
<tr>
<td>Liquid Funds</td>
</tr>
<tr>
<td>Gilt Funds</td>
</tr>
</tbody>
</table>

(*Contingent Deferred Sales Charge is where Exit Load is linked to the holding period with longer holding periods being exempt from Exit Load and shorter holding periods being charged around 0.5%). (Source: Outlook Money, 2007)
Load helps in imparting discipline to investing. The CDSC of 0.5 per cent in debt funds exists to ensure that an investor stays in the fund for more than six months. This benefits the investors too as the minimum holding period for these funds should ideally be one year and more (Mutual Fund Insight, 2008).

Most equity funds charge an entry load and no exit load. Loads are generally higher in actively managed equity schemes than in passively managed ones (Business World, 2008).

SEBI has abolished load on mutual fund investments made directly from fund companies, either through their offices and service centers, or online. SEBI has said that if there is no distributor in the picture then the fund company must not take from the investor the amount meant for the distributor (Kumar D, 2008).

2.2.8 Tax Benefits as a Marketing Strategy

Various tax laws govern the mutual fund investments, some which lower the returns and some of which boost them. There are ways to use these laws with the larger objective of maximizing an investor’s return.

- **Capital Gains**
  - **Equity Schemes**
    
    There is no tax on long term capital gains, provided the sale transaction is subject to securities transaction tax. Short term capital gains are taxable at 10%, provided the sale transaction is subject to securities transaction tax. Further, surcharge will be applicable on the tax. Additional surcharge of 3% towards education cess will be applied on the sum of the 10% tax and the surcharge.

  - **Debts Schemes**
    
    Short-term Capital Gains are added to the other income of the investor for taxation purposes. Therefore, the investor would pay tax at ones
applicable marginal rate including surcharge. A resident individual has two options for taxation of long-term capital gains:

1. **With Indexation**
   A resident investor can choose to index the cost of acquisition for the purpose of calculating capital gain. The inflation adjusted cost of acquisition being higher than the basic cost of acquisition; indexation helps in reducing the capital gains. An investor opting for indexation would pay income tax on long-term capital gains at the rate of 20%, plus the applicable surcharge.

2. **Without Indexation**
   An investor can choose not to take the benefit of indexation. In such a case, the capital gains will be higher, but it would be taxed at a lower rate of 10% plus the applicable surcharge.

Logically, if the investment has been held for a longer period of time, then the benefit of taxation would more than make up for the higher income tax rate.

If on the other hand, the investment has been held for a shorter period (but for more than a year), and if the change in index rate during the period is less than 10% plus applicable surcharge, then it would be better not to take the benefit of indexation. Investors should opt instead to pay tax at the lower rate of 10% plus applicable surcharge (Sankaran S, 2007).

**Double Indexation**
This refers to the practice of taking the benefit of indexation for two years, while holding the investment for just over a year.

For example, if an investor buys units on 30\textsuperscript{th} March, 2006 and sells them on 2\textsuperscript{nd} April 2007, the holding period of the investment works out to just a few days more than a year. However, her indexed cost of acquisition would be worked out as follows:
Cost of Acquisition X Index Number for 2005-06 / Index Number for 2007-08.

Thus, the investor gets the benefit of indexation for two years, namely 2006-07 and 2007-08, although the investor has held on to the investment for just around a year. This is a perfectly a legal tool to plan taxes (Sankaran S, 2007).

**Set-off of Losses**

Tax laws allow capital gains to be setoff against capital losses- short-term losses against short-term gains, long-term losses against long-term gains. This is a good way to save tax. Capital gains and losses can be carried-forward for 8 years. In a given year if an investor makes a long term gain of Rs 10000 from the sell of Debt Fund units, under normal circumstances, at a flat 10% rate, the investor would pay capital gains tax of Rs 1000 but if the investor booked capital losses of Rs 10000 by selling some losing investments, the investor wont need to pay anything (Outlook Money, 2007).

**Section 80C Deduction**

An investor can invest up to Rs 100000 in specified instruments, within limits, and avail a deduction from their taxable income. Among the specified instruments are equity-linked savings schemes (ELSS) and Pension Funds (Outlook Money, 2007).

**Dividend Distribution Tax**

The government wants to tax dividends, to earn more revenue. Investors want the government to lay off their income, for obvious reasons. Same with the mutual funds, who feel such a levy, drives away investors. The government has frequently changed the rules. So, dividends have been tax-free one year, taxable in the hands of investors the next, taxable in the hands of mutual funds the following years.
For the financial year 2007-08 dividends are tax-free in the hands of investors. The phrase “tax-free” is actually a misnomer in the case of debt funds, which has to pay a dividend distribution tax of 16.99%. Liquid and Money Market Funds have to pay a higher dividend distribution tax of 28.32%. All debt funds pay this tax not from their own pockets, but from the investor returns, which effectively means that it is the investor who pays the tax. Equity funds however are exempt from paying any dividend tax in 2006-07.

For minimizing the tax outflow, investors need to weigh their investment needs against tax considerations, and then take a decision.

- Debt Funds: The 16.99% dividend tax makes the growth plan more tax-efficient than the dividend plan. If a debt fund earns Rs 100, it can pass on only Rs 85.50 on to the investors under the dividend plan, as Rs.14.50 (16.99%of Rs.85.50) will go towards meeting the dividend tax. For liquid plans the tax is higher at 28.32%. A growth plan, on the other hand, will pass on the entire Rs.100 to the investors. If the investor sell his units within a year, and if the investor come in the 20% or 30% tax brackets, the investor pay more tax than in the dividend option. But if he sell his units anytime after a year, he will have to pay a maximum tax of 11.33% (10%capital gain tax + surcharge + education cess), which, in this case, is Rs.11.33. Returns advantage under the growth plan: 3.17% points (14.50-11.33). Therefore, if the investor doesn’t bank on his debt fund investments to meet periodic income needs, she can prefer the growth option. Even if the investor need regular income, she needn’t sign up for the dividend plan, and see a significant amount from every payout go out as tax. Most mutual funds offer another tax-efficient plan that is an excellent alternative to dividend plans: systematic withdrawal plans, or SWPs.
Equity Fund: At the time of writing, since the equity funds didn’t have to pay any dividend tax and dividends were tax free in the investors hands, the dividend plan was more tax-efficient than the growth plan for holdings periods of less than one year. Gains from growth plans, on the other hand, are subject to short-term capital gains tax of 10%. For more than 1 year, tax ceases to be the deciding factor as long-term gains are also exempt from tax. However, if the dividend tax is extended to equity funds, this could change. Ideally, while choosing plans an investor should consider the dividend tax. One of dividend plans’ virtues is the ability to book profits for investors during good times. This feature is critical in equity funds, whose NAV’s rise and fall with the market. Typically, equity funds declare dividends during good times. In growth plans, though, the onus of booking profits is on the investors. If investors don’t use this window, chances are, when the market falls, so will the investors scheme’s NAV. So while investors in the dividend option would have encashed their gains, in part or in full, those in the growth option might see their paper profits evaporate. Investors in equity funds are exempt from paying long-term capital gains. However, they are required to pay a securities transaction tax of 0.25% (Outlook Money, 2007).

2.2.9 Developments in Mutual Fund Marketing
Marketing is a dynamic process which changes with the new developments in the socio-financial environment. The Indian market witnessed many changes in terms of the emergence of intra-and inter-institution competition, market regulations, innovation in products, investors’ awareness, technological development, and so on. The measures taken to improve marketing include widening the product basket, enlarging the chain of product placement and improved disclosure
with respect to the product. The offer documents have become more structured and contain information relating to service and management. The use of technology for communication selling and servicing has also improved the marketing of mutual funds. Further, as a result of the competition arising from the entry of private sector mutual funds, investors now have a wider choice in terms of products, costs and management styles. The media is also playing a very active role in disseminating information - by encouraging debate and focusing on the performance of mutual funds, it is facilitating the process of informed decision-making by investors. In addition, the prudential regulations implemented by SEBI, which are in many respects comparable to the best in the world, have enhanced the accountability of AMCs and their directors, as well as the trustees of funds. The marketing of mutual funds is a critical activity today and calls for a futuristic vision with respect to products, as well as a more scientific and structured approach for market penetration and product placement. The other developments include the introduction of training and self-regulations for marketing personnel and programme for investors' education, both initiated by the AMFI (Sadhak H, 2003).

2.2.9.1 Marketing Code for Mutual Funds
The marketing code aims at preventing mutual funds from using deceptive statements and publicity to attract investors. Mutual Funds must adhere to specific rules regarding the sale, distribution and advertising of mutual funds. Advertisements or sales literature must be carefully worded and explained. The advertisement for each scheme shall disclose investment objective for each scheme. The offer document and advertisement materials shall not be misleading or contain any statement or opinion, which is incorrect or false. These steps
ensure that potential investors are aware of the benefits as well as the potential risks involved in mutual fund investing.

With a view to ensure that an asset management company may not in promoting its schemes use untrue and misleading information or withhold important facts from investors, SEBI has prescribed an advertisement code. Advertisements in respect of every scheme shall be in conformity with the Advertisement Code (IIBF, 2007). Some of the key limitations of advertising are described below:

- Advertisement through hoardings and posters: in addition to advertising copy, all advertisement must carry the following statement:

  “Mutual Fund investments are subject to market risks, read the offer document carefully before investing.” The compliance officers are responsible to ensure that the statements appearing in such advertisements are in legible fonts.

- Advertisements through audio-visual media: the statement “Mutual Fund investments are subject to market risks, read the offer document carefully before investing” have to be displayed on the screen for at least 2 seconds, in a clearly legible font-size covering at least 80% of the total screen space, and accompanied by a voice-over reiteration. The remaining 20% space can be used for the name of the mutual funds or logo or name of scheme, etc. SEBI has mandated that with effect from April 01, 2008 the time for display and voice over of the standard warning be enhance to 5 seconds in audio and audio-visual advertisements. While the move will enhance the mutual fund quotient of the investors for the industry it means more of the marketing expenses. AMCs expect their marketing cost to go up by 20%- 50% (Mutual Fund Insight, 2008).
• Performance Advertisements: all performance advertisements disclosing return statistics have to also mention the returns on the benchmark indices during the same time periods. While advertising returns by assuming reinvestments of dividends, if distribution taxes are excluded while calculating the returns, this fact needs to be disclosed.

• Ranking Advertisements: any advertisement or sales literature that mentions a ranking, should consider the current ranking for the most recent quarter or such other periodicity or frequency as may be applicable (Sankaran S, 2007).

2.2.9.2 Informative Offer Documents

The offer document is a key document that provides essential information about the scheme to help investors make informed decisions about whether to purchase the units being offered.

Keeping in mind the profile of prospective investors, the regulations provide that information in the offer document has to be presented in “simple language and in a clear, concise and easily understandable manner.”

Minimum disclosure requirements are set out in SEBI’s standard offer document. Besides, SEBI has also laid down certain “standard observations” that need to be incorporated in the offer document.

The standard offer document prescribes the “nature of the disclosures” but not the “lay out or the language”, except that Items I (Cover Page), II (Definitions) and III (Risk Factors) must appear in the same numerical order in the offer document. Here again, the mutual fund may include Item III as a part of Item I. A mutual fund is free to add any other disclosure provided such information is not presented in an “incomplete, inaccurate or misleading manner”.

121
In the case of close-end schemes the offer document is issued only once when launched. Since open-end schemes sell units on an ongoing basis, mutual funds have to revise and update the offer document of such schemes regularly. A revised offer document needs to be printed at least once in two years. When an open-end scheme has completed one year and there after each year, the condensed financial information of the scheme has also to be included in the offer document.

Application forms for schemes of mutual funds have to be accompanied by the Key Information Memorandum, the format for which is outlined by SEBI. The Key Information Memorandum (KIM) is a concise version of the offer document that is more easily available at the office of various intermediaries who sell the units. The investor, however, has the right to insist on the detailed offer document (Sankaran S, 2007). KIM gives the crucial details of the scheme, its goal and investing rationale. It also specifies where the scheme will invest its funds—in equity, debt or both. A KIM tells about the scheme’s asset allocation pattern. It helps to match the scheme’s risk profile with that of an investor and also compare various schemes to avoid overlapping. KIM contains information about a scheme’s performance vis-à-vis its benchmark index. For a new scheme an investor can check the fund house’s track record. Details of entry and exit load are mentioned in a KIM (Kohli S, 2007).

The mutual fund has to file the offer document and key information memorandum for the proposed scheme with SEBI. A twenty one-working day window is provided for SEBI to give its comments. The AMC needs to incorporate the observations the SEBI makes on the filed offer document (Sankaran S, 2007).
2.2.9.3 Innovative Products

A large number of new types of schemes- sector funds, gilt funds, bond funds, index funds, special purpose funds etc- with a number of options have been launched to take care of varied expectations of investors in the emerging market (Sadhak H, 2003).

Fund houses should not use exotic names as it can lead to misunderstanding among investors that a new fund may be different when the reality is that the fund has the same objective as that of an existing one (Bansal L, 2004). Catchy names are a good marketing ploy and can work magic with investors, and market willing, with performance as well (Gajra R, 2008).

There is a lot of clutter there in the mutual fund industry in India. At the first level, there is clutter in what an investor can buy. Then at the next level there are numerous rankings and ratings of mutual funds (Dave S.A, 1991).

The problem is that most of these rankings do not agree with each other. Faced with these, how an investor chooses which scheme or product or brand to buy? What this means is that an investor should not only watch for No.1 or No.2 since no product can remain at the top of the charts consistently over say 10 years (Varshney P.N. & Mittal D.K, 2000).

2.2.9.4 Skill Formation and Investors Education

In order to promote best selling practices among its members, AMFI mooted the idea of allowing only trained agents to sell mutual funds. It is mandatory for the agents to have certification to operate (Sadhak H, 2003). Amfi has also proposed for compulsory certification of fund managers. In developed markets like the US, fund managers are mandated to pass an exam before they qualify as fund managers (Kohli S, 2007).
The Securities and Exchange Board of India (SEBI) and Association of Mutual Funds of India (Amfi) has taken regulatory initiatives to control malpractices, like misselling, in the mutual fund industry. Fund houses have to ensure that their agents or distributors do not indulge in any unethical practice while selling/marketing mutual funds. If any intermediary does not comply with the code of conduct, the fund house has to report it to Amfi & SEBI.

Amfi has stressed upon periodical training to distributors and agents to keep them abreast with latest developments in the industry and self discipline by the intermediaries is emphasized (Shah Nilesh, 2006). The investors’ education programme initiated in collaboration with the UTI Institute of Capital Market and Stock Exchanges in different parts of the country, is well designed and has helped spread awareness among investors (Sadhak H, 2003). The concept of investor education never existed a decade ago and crystallized only after the IPO scam in 1994-95. The electronic media has also contributed a lot to information dissemination among the common people (Desai D, 2007).

**2.2.9.5 Servicing Standards**

Good servicing is considered to be a right of the investor to day, and the investors’ rights are stated clearly in the offer documents. The following are a few aspects of servicing.

- **Customer Sensitivity:** The improvement in the standards of service is reflected in the increased sensitivity to customers. Mutual funds have tried to ensure greater customer sensitivity by appointing customer relationship manager.

- **Cheque-writing Facility:** Many mutual funds provide the cheque-writing facility, particularly to investors in money market and liquid funds. To avail himself of this facility, an investor must open a bank account with a designated bank.
• Electronic Clearing Service: Most mutual funds today use the electronic clearing service to make payments (interest/dividend/income) directly to the bank account of the unit-holders.

• Other Services: The other facilities provided to the investors include services pertaining to exchange between schemes, automatic reinvestment, switching and regular withdrawals (Sadhak H, 2003). All mutual funds are required to send physical accounts statements or unit certificates to all investors at least once a year along with the scheme’s annual report around the month of June. The market regulator has also mandated that fund should send physical account statements once a calendar quarter to all investors who have opted for the Systematic Investment Plan or the Systematic Transfer Plan (Adajania K, 2006).

• Call Centers: Many mutual funds have opened call centers which provide investors with information related to funds.

• Mutual Fund Websites: AMFI has launched a website displaying valuable information on Indian mutual funds. Besides this, different mutual funds have their own websites which provide information related to the fund, its management, products, services and performance (Sadhak H, 2003). Inflows and outflows of funds are available on the Amfi website, on a fund-wise and category-wise basis. It is updated monthly. For scheme wise data, scheme fact sheets can be looked into. These are usually available on the websites of the respective fund houses.

• ATM Card: Reliance mutual fund in association with HDFC Bank offers investors in Reliance Regular Savings Fund, an ATM cum Debit Card that allows an investor to withdraw his investments in the fund at any VISA enabled ATM (Adajania K. 2006).
2.2.9.6 Direct Distribution Network

An important channel of marketing that is being used successfully in many western countries is the direct distribution network. Direct distribution is cost-effective and is used to serve the more sophisticated customers, like NRIs and corporate and institutional investors. Since direct marketing provides customized services, it would help improve services to the existing customers, and would also attract new customers. The following steps could be taken to develop an effective direct marketing network.

• Generate Investors’ Interest: Mutual fund should promote the interest of customers in their products through advertisements in newspapers and magazines, direct mailing and the electronic media.

• Respond to Investors’ Enquiries: This could be done over the telephone, by mail, through personal visits, or by sending marketing materials, prospectus, etc.

• Convert Investors’ Interest into Sales: Sending welcome kits and information to the investors would help achieve this. Investors should be informed about post-investment servicing facilities. Assistance should be offered for assessing investment needs and the ability to tolerate risk. It is a fact that all the interest could not be converted into investment and there will be some expenses which will appear to be wasteful. However such expenditure may pay off later like the person may decide to invest in the fund at some future point.

• Direct distribution is thus a very important strategy particularly for long-term growth (Sadhak H, 2003).
2.2.9.7 Other Channels of Marketing

- Internet: In an era of universal banking, the banking network has emerged as an important distribution channel. As for the internet it is becoming the most powerful means of marketing and cannot be ignored. Net marketing can provide easy access to global market. (Sadhak H, 2003).

- Data Based Marketing: Marketing requires aggressive attempts at convincing the prospective customer through facts, figures and logic. With the increased level of awareness, greater access to information and availability of competitive products, investors need to be convinced through data on the comparative performance of different funds, servicing facilities and projections for the future. Soft skills are not enough, one need product and market knowledge in areas that are not easy to understand. Customers now expect better services in the form of more informed selling (Halan M, 2007). Therefore, marketing activity is highly dependent on a sound and strong data-base.

Finally, the success of marketing does not depend only on the marketing strategy and efforts; the track record of investment performance is the most important though silent influence. Marketing can facilitate the distribution of products; expand the reach of products, help in designing the appropriate products and rendering high-quality services, and built up the image of prompt service providers, but it is the expected returns which have the final say in determining investment decisions. Marketing of mutual funds, therefore, cannot be seen in isolation and marketing strategy should be part of a composite strategy that incorporates investing, serving and marketing (Sadhak H, 2003).

2.2.10 Marketing Analysis for Mutual Funds

Mutual funds products are market-driven and for a market-driven product, its designing, pricing, distribution, and promotion assume critical
importance. Since the most important determinant of the success of any financial product is consumer satisfaction, mutual funds need to optimize customer satisfaction along with cost minimization in the deregulated competitive market. Therefore, product-related decisions must be made within the framework of economies of scale after considering the opportunities in the market, the size and future expansion in the market, consumer expectation, and availability of alternatives and so on. This is where market analysis and market research become important.

The basic aims of market analysis for any mutual fund are: to reduce the risks of operation, monitor marketing activities so as to control undesired development and develop a wider, sophisticated network of market information (market intelligence).

Market analysis involves four areas:

- Environment-related,
- Industry-related,
- Company-related, and
- Customer-related.

**Environment-related Factors**

Environment-related Factors are those that determine the total market size and indicate the present and future market potential. The relevant data would pertain to the growth of the GDP, NNP, Per Capita NNP, Savings, etc; growth of disposable income; flow of funds in the economy; trends in fiscal, financial and monetary policy; state of the capital market; and state of the money market.

**Industry-related Factors**

The comparative advantages and disadvantages of mutual funds vis-à-vis other savings media need to be examined to determine the industry’s position. Some of the important industry-related factors that must be analysed are:
• Flow of funds in the national economy and the distribution of household surplus among various instruments;
• Comparative advantages, viz. returns, tax benefits, etc, of the competing instruments;
• Level of customer satisfaction for various alternative products;
• Possibility of entry of new competitive products;
• Changes in economic laws and their impact on the mutual funds industry (Sadhak H, 2003).

Company-related Factors
In addition to the area of market research mentioned above, the company (mutual fund) has to carry out research to identify its own strengths, weaknesses and competitive positions, as well as ability to penetrate the market, and increase competitive capacity (Sadhak H, 2003).

Customer-related Factors
How do customers (investors) perceive the mutual fund company, its products and services? The preferences and expectations of customers are constantly changing due to the changes in the external environment. No mutual fund can ignore the customer. Mutual funds, therefore, need to be well informed about:

• The preferences and expectations of customers;
• Changes in the preferences of customers and expected changes due to deregulation of financial market; and
• Quality of after-sales services and grievances of customers (Sadhak H, 2003).

2.2.11 Mutual Fund Rating
There has been a degree of anarchy in the capital market in the recent times, particularly due to market transition and expansion as well as the changes in the nature and intensity of competition. The unpredictability
has been further compounded by group control of the market, so that very often, the market does not function as a free market but as a slave of groups of vested interest. The motivated and concerted actions of these groups suppress the natural market signals, which mislead the investors. The suppression of the natural market signals, which are expected to represent the implicit and explicit changes in the macro economic fundamentals of the market, makes investment decisions an extremely risky proposition and puts the investor in a vulnerable position. It is often thought that the mutual funds, which are considered to have expertise in the management of funds, can reduce the investors' vulnerability. However, mutual funds are not always safe and, therefore, the investor should be well informed before he decides which fund to invest in, even if it is a debt fund (which is generally thought to be risk-free).

Experience has shown that investment in debt and money market funds may be even riskier than investing in other funds because it may be difficult for risk-averse investors to absorb the given level of risk entailed which equity investors, who are basically risk-takers, could absorb. It is often difficult for an investor to assess the degree of risk involved in a particular fund because of the absence of information on matters like changes in the funds’ managers, their management strategies and styles, and unanticipated changes in the macro economic policy and environment, etc. mismatch between a fund’s performance and the investors’ expectations could be minimized if investors were in a better position to assess the risk entailed. This could be achieved through scientific self study or with the help of funds rating. Rating may help minimize the risks to some extent, provided that the rating agency is capable of assessing the implicit risks in a professional manner.
As a result of the growing concern about the risks entailed in investments in mutual funds, investors all over the world have started relying on risk assessment by rating agencies. The major credit rating agencies, like S&P, Moody’s and Fitch IBCA, offers services for rating mutual funds. Apart from the regular credit rating agencies, there are agencies that specialize in rating mutual funds. For example, Lipper Analytical Services and Morningstar provide rating services to mutual funds investors in the US and Fund Research does so in the UK. Even countries like Mexico, Argentina and Taiwan where mutual fund are a relatively new phenomenon, are placing increasing emphasis on rating. In fact, rating of debt funds is mandatory in Mexico.

There are two main types of funds ratings. One type evaluates a fund on the basis of its past performance, volatility and expenses while the other focuses more on the future and provide ratings on the explicit risks. Lipper Analytical Services and Morningstar follow the former method and Fund Research the later. Whatever the method, the broad objective of a rating agency is to provide the right kinds of signals to investors regarding the explicit and implicit risks arising from a fund’s investment strategy, portfolio of securities, allocation strategy and the efficiency of its management on the basis of its past track record (Sadhak H, 2003).

Resume

A marketing plan for mutual funds services needs to stress the firm-product-customer relationship. It involves product planning, branding, pricing, distribution, promotion and servicing. Product planning involves different product lines to be offered to the investors, quality, design, range of services etc. Branding involves selection of product name and brand policy. Price of units, rates of incentives, rates of commission to agents or brokers are the principal components of pricing strategy. Channel to be used for selling the product – directly to the customers or
through intermediaries like agents, brokers etc. are also to be decided. Promotion involves promoting sales through advertisements, road shows etc. After sales services – provided directly by a mutual fund to customers or through intermediaries like registrars of the issue etc. are the parts of the formulation of a marketing strategy.

In a market which is very competitive, pricing policy plays a vital role in expanding the market for a product. In case of mutual funds cost of entry to and exit from a fund has a huge impact on the rates of return to the investors and thus is an important factor as far as marketing strategy is concerned.

Tax benefits can be considered to be an incentive for investing in any financial instrument and mutual funds is no exception. Tax benefits arising from the legal provisions relate both to mutual funds and also to its investors. There are ways of using these provisions with the larger objective of maximizing once returns.

Marketing being a dynamic process changes itself as the socio financial environment changes. With the change in the Indian market measures have been taken to improve the marketing of the mutual funds which includes development and thus widening of the product basket to take care of varied expectations of the investors in the evolved market, more informative and self contained literature with respect to the product for more informed decision making, new channels to market the product, different skill formation and various new concepts have been introduced to improve the standard of servicing.

The mutual funds products being market driven require product related decision to be made after realizing the opportunities in the market, the present size and the future growth the market can achieve, consumer expectation, and available alternatives and so on. Market analysis helps in
taking such product related decisions and involves study of environment, industry, company, and customer.

Mutual funds having expertise in fund management can reduce investor’s exposure towards risk. However, mutual funds are not always safe and as a result of the growing concern about the risk involved in investments in mutual funds, investors have started to rely on risk assessment by different rating agencies.
2.3 Fund Management Fundamentals

The goal of portfolio management is to assemble various securities into a portfolio that address investor needs and then to manage those portfolios to achieve investment objectives. The investors' needs are defined in terms of risk, and the portfolio manager maximizes return for the investment risk undertaken.

In a mutual fund, portfolio management is at the heart of the activity-chain. Portfolio manager, popularly known as fund manager carries on his function. Each scheme of mutual fund has a designated fund manager who is responsible for constructing, managing and protecting portfolios to achieve pre-defined investment objectives. SEBI requires a dedicated fund manager for each scheme so that responsibility for the investment decisions can be clearly allocated and identified.

The portfolio management process initiates by investment advisory functions and dealing activities and is succeeded by investment monitoring function.

Investment advisory department provides research support to the department of fund management.

Given the kinds of scheme the mutual fund has, its fund management department specifies a set of securities that have to be regularly tracked. For such securities, various reports may be prepared by the research department. Research analysts study the financials of the companies in detail and prepare valuation reports. They form a risk-return profile of the company. This department provides research support not only to the fund management team but also to the investment-monitoring department.

Investment advisory department normally maintains dummy/model portfolios. The objective of this portfolio is to be reflective of the research recommendations of the department. These model portfolios are
actively managed and are made available to fund managers. This is also used by the fund managers to compare the actual performance of their schemes vis-à-vis the model portfolio.

Department of dealing acts as a support function to the fund management activity. It handles activities relating to the secondary market operations and tries to obtain the best possible price for purchase/sale of securities. The department of dealing is responsible for trading in the market (IIB&F, 2007).

The success of fund management depends on the quality of the fund’s managers, and the structure and quality of decision making process. This includes the following steps:

- Determining the investment objective in the light of investors’ attitude towards risk, level of risk aversion, and ability to bear the risk;
- Constructing an ideal portfolio in relation to the expected returns and risks, and determining the risks and returns for various time periods of each asset class;
- Taking asset allocation decision to determine optimum allocation of assets in the portfolio;
- Selecting individual securities in the portfolio by estimating the risks and returns and allocating an optimum of such assets in the portfolio; and
- Selecting appropriate performance indicators to analyse the portfolio performance in view of the investment objectives, risk elements, etc.

Fund management performance is determined basically by securities selection, portfolio construction, asset allocation, management style and market timing.
2.3.1 Defining Investment Objectives and Identifying the Constraints

Like any individual investor, an institutional fund manager has certain investment objectives. These are determined by the basic purpose of the investors and the level of risk tolerance. The objective may be one or more of the following: current income, growth and income, capital appreciation, capital preservation, or realizing tax benefits with reasonable income growth (Sadhak H, 2003).

Table-2.6 Indian Mutual Fund Schemes

**Diversified Equity Funds** (Sankaran, S, 2007)

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Investment Objective</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open-ended Equity Growth Scheme</td>
<td>To generate long-term capital growth from a diversified portfolio of predominantly equity and equity-related securities</td>
<td>BSE 200 Index</td>
</tr>
<tr>
<td>Aggressive Growth, Open-ended Diversified Equity Scheme</td>
<td>To provide medium to long term capital appreciation as primary objective and income as secondary objective.</td>
<td>S&amp;P CNX 500</td>
</tr>
<tr>
<td>Growth, Open-ended Diversified Equity Scheme</td>
<td>To provide growth of capital plus regular dividend through a diversified portfolio of equities, fixed income securities and money market instruments.</td>
<td>S&amp;P CNX 500</td>
</tr>
<tr>
<td>Steady Growth, Open-ended Diversified Equity Scheme</td>
<td>To provide medium to long term capital appreciation</td>
<td>BSE Sensex</td>
</tr>
<tr>
<td>Open-ended Equity Growth Scheme</td>
<td>To achieve long term growth of capital</td>
<td>BSE 100.</td>
</tr>
<tr>
<td>Scheme</td>
<td>Objective</td>
<td>Index</td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Open-ended Equity Growth Scheme</td>
<td>To generate capital appreciation</td>
<td>BSE Sensex, S&amp;P CNX Nifty.</td>
</tr>
<tr>
<td>Open-ended Equity Growth Scheme</td>
<td>To achieve capital appreciation</td>
<td>BSE Sensex, NSE Nifty.</td>
</tr>
<tr>
<td>Open-ended Equity Growth Scheme</td>
<td>To achieve capital appreciation in the long term.</td>
<td>BSE Sensex, NSE Nifty.</td>
</tr>
<tr>
<td>Open-ended Equity Scheme</td>
<td>To generate long-term capital appreciation</td>
<td>S&amp;P CNX Nifty.</td>
</tr>
<tr>
<td>Open-ended Scheme</td>
<td>To generate long-term capital appreciation</td>
<td>CMIPex</td>
</tr>
<tr>
<td>Open-ended pure Growth Scheme</td>
<td>To provide capital growth</td>
<td>BSE Sensex</td>
</tr>
<tr>
<td>Open-ended Equity Scheme</td>
<td>To achieve capital appreciation</td>
<td>S&amp;P CNX Nifty.</td>
</tr>
<tr>
<td>Open Ended Balanced Fund</td>
<td>To provide an enabler to adult female persons in pooling their own savings and/or gifts into an investment vehicle so as to get periodic cash flow near the time of any chosen festival /occasion or to allow income/gains redeployed in the scheme and repurchase units partially or fully as and when desired</td>
<td>CRISIL MIP Blended Index</td>
</tr>
<tr>
<td>Open Ended Equity Fund</td>
<td>To provide capital growth as well as to make periodical distribution of income from investment in stocks of respective sectors of the Indian economy.</td>
<td>BSE 100</td>
</tr>
<tr>
<td>Open Ended Equity Fund</td>
<td>To provide capital growth over a period of time as well as to make income distribution from</td>
<td>BSE 200</td>
</tr>
</tbody>
</table>
investment in stocks of select growth oriented sectors of the Indian economy.

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Investment Objective</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open-ended Growth Scheme</td>
<td>To provide long-term growth of capital. The secondary objective is income generation and distribution of dividend.</td>
<td>BSE 200</td>
</tr>
</tbody>
</table>

### Sector Funds

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Investment Objective</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sectoral Growth, Open-end Fund</td>
<td>To provide long term capital appreciation</td>
<td>ET Brandex</td>
</tr>
<tr>
<td>Open-Ended Banking Sector Scheme</td>
<td>To generate continuous returns</td>
<td>S&amp;P CNX Banks Index</td>
</tr>
<tr>
<td>Open-Ended Pharma Sector Scheme</td>
<td>To generate continuous returns</td>
<td>BSE-Health Care Index</td>
</tr>
<tr>
<td>Open-Ended FMCG Sectoral Fund</td>
<td>To generate long term capital appreciation</td>
<td>CNX FMCG Index</td>
</tr>
<tr>
<td>Open-Ended Equity</td>
<td>To provide capital growth as well as to make periodical distribution of income from investment in stocks of respective sectors of the Indian economy</td>
<td>BSE Bankex</td>
</tr>
<tr>
<td>Open-Ended Equity Fund</td>
<td>To provide capital growth over a period of time as well as to make income distribution from investment in stocks of selected growth oriented sectors</td>
<td>Petro Index maintained by India Index Services and Products Ltd.</td>
</tr>
</tbody>
</table>
**Balanced Funds**

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Investment Objective</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open-ended balanced schemes</td>
<td>To provide periodic returns and capital appreciation over a long period of time, from a judicious mix of equity and debt investments, with the aim to prevent/ minimize any capital erosion</td>
<td>BSE Sensex, NSE Nifty</td>
</tr>
<tr>
<td>Open-ended balanced fund</td>
<td>To provide a good investment opportunity to investors who do not wish to be completely exposed to equity markets, but is looking for higher returns than those provided by debt funds.</td>
<td>CRISIL Balanced Fund Index</td>
</tr>
<tr>
<td>Open-ended Income and Growth Scheme</td>
<td>To provide regular returns and capital appreciation</td>
<td>C Balance Ex</td>
</tr>
</tbody>
</table>

**Debt Funds**

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Investment Objective</th>
<th>Benchmark Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open-ended Income and Liquid(gilt) scheme</td>
<td>To generate risk free return</td>
<td>I-Sec Si-BEX</td>
</tr>
<tr>
<td>Open-ended Gilt Fund (Investment-PF)</td>
<td>To generate income</td>
<td>ISecLi-Bex</td>
</tr>
<tr>
<td>Open-ended debt scheme</td>
<td>To generate reasonable returns with low risk and high liquidity</td>
<td>C Fund-LX</td>
</tr>
<tr>
<td>Open-ended Gilt fund</td>
<td>To provide risk free returns to investors even for a shorter duration</td>
<td></td>
</tr>
</tbody>
</table>
Every fund manager has to perform within certain given constraints, which are as follows:

- The basic investment objective.
- The time horizon has a significant influence on the funds management and performance. Investors may have short, medium or long-term objectives, which need to be reflected in the time horizon of the realization of returns and expected risks.
- Liquidity is considered a limiting factor for the management. A certain amount of liquidity needs to be maintained through the time horizon of the fund because of the determined and undetermined outflow of cash, considering that mutual fund redemption can take place at any time.
- The income from the funds is taxed.
- Institutional fund management has to be carried out within the regulatory framework of investment, for example, SEBI guideline for mutual funds.

2.3.2 Portfolio Selection

2.3.2.1 Harry Markowitz model

An efficient portfolio is one which produces a given expected return with a minimum of risk. Harry Markowitz has developed a model for such a portfolio, wherein he attempts to quantify the risk of a portfolio and develop a methodology for constructing an optimal portfolio. His model is based on the expected return to the investors and the variance of return. The model is based on the following assumptions:

- The portfolio expected return is the weighted average return of the securities in the portfolio.
- The portfolio risk consists of the variance of its return.
• An optimal portfolio is characterized by a risk adjusted return (termed as the utility of the portfolio), which is the expected return of the portfolio minus a risk penalty. The optimal portfolio for an investor would be one from the opportunity set that maximizes utility.

2.3.2.2 William Sharpe model
According to William Sharpe inclusion of a stock in portfolio would depend on the excess return to the Beta ratio, which is calculated by taking into account the expected return of a stock, the return from risk less assets and the expected change in the return of the stock associated with a 1% change in the market return. Stocks are therefore, ranked according to the excess return (highest to lowest), and those stocks which are above the cut-off point are to be included in the portfolio. The cut off rate is decided with reference to the variance in the market index and the variance of the stock’s movement that is not associated with the market index. Finally, the percentage of funds to be invested in each security is calculated to establish an optimal portfolio.

2.3.2.3 CAPM
The portfolio theory of Markowitz has been extended to develop a capital market theory which provides guidance in the pricing of assets in the capital market. This model is known as the Capital Asset Pricing Model (CAPM). According to the CAPM, the risk associated with any asset has two elements – the undiversifiable market risk and the stock-specific diversifiable risk. Risk-return relationship focused in CAPM through securities market line shows that the systematic risk, that is, undiversifiable market risk is the only important determinant of expected return (Sadhak H, 2003).
2.3.3 Portfolio Optimizer

Fund managers use portfolio optimizer for constructing optimal portfolios subject to their respective investment constraints. They use this product for the following purposes:

- For controlling the risk of their portfolios.
- As a decision support tool that can help in studying the impact of any portfolio re-balancing decision on the portfolio's overall risk.
- The product provides daily and long-term return at risk estimates.
- The product allows the fund manager flexibility in incorporating his investment constraints such as not having investment in excess of 10% of its NAV in the unlisted equity shares or equity related instruments of any company.

2.3.4 Asset Allocation Strategy

Asset allocation is the most important aspect of investment decision. Asset allocation means the distribution of funds of a portfolio among different instruments (stocks, bonds, cash, etc.) keeping in view the overall investment objective, level of risk-bearing ability of the investors and the time horizon.

The selection of securities and construction of the portfolio are, no doubt, important management decisions, but perhaps more important is the selection of an appropriate blend of assets in the portfolio. In doing this, the management must consider the level of risk-aversion of the investors, while at the same time, optimizing the expected return from each class of assets.

2.3.4.1 Strategic Asset Allocation

The strategic asset allocation (SAA) approach assumes that the securities risk is unpredictable but portfolio volatility can be managed by selecting a well-designed mix of assets in the portfolio. The performance of a portfolio under SAA is not measured by its ability to satisfy the liability
relative to a market index or even an absolute rate of return; the success of the approach depends largely on periodic portfolio correction, depending on the market changes and portfolio goal. The backbone of SAA is the construction of a police benchmark or normal portfolio, which includes asset classes of index funds, the weightages being assigned according to the SAA approach. The real portfolio is supposed to follow the normal portfolio, which is treated as the benchmark. The performance of actual portfolio is then compared with the benchmark portfolio.

Among the important methods, adopted under this approach is Capitalization Based Strategic Asset Allocation. In this method securities are usually selected from an index-equity, bond, property, etc, which account for a certain percentage of the index capitalization. Therefore, there is no difference between the portfolio and the index quality. The performance of the portfolio is then compared with that of the index. The other methods adopted for determining weightages are mean variance optimization, in which an efficient frontier is calculated first and an efficient portfolio constructed subsequently; asset-liability, in which asset distribution is modeled in relation to the liabilities, tax position and time horizon of investment; and median manager which follows the market.

2.3.4.2 Tactical Asset Allocation

This constitutes an active allocation strategy, which is adopted to optimize short-term performance through readjustment of the asset portfolio, keeping in mind the volatility of the market and short-term deviations in the market value of assets. The TAA strategy thus attempts to manage market risk through the adjustment of short-term returns. According to Terry J. Waston (1933), the process of TAA can be broken down into three stages:
• Research on and analysis of expected returns, variances and co-variances of asset classes: this enables fund managers to have an idea of the future returns of different assets, their variances, and the co-variances of the expected returns between pairs of asset classes.

• Determining an array of efficient portfolios: by using mean-variance analysis, the fund manager can construct a whole set of portfolios which incorporate the various levels of risk that the investors can bear. Since higher returns always entail higher risk, best portfolios can be developed on the basis of the investors’ risk-tolerance level, and assets can be allocated on the basis of the expected returns and risks.

• Determining the risk-return combinations of optimum portfolios: finally an optimum portfolio can be selected from among the array of portfolios constructed, depending on the investors’ investment objective.

2.3.4.3 Dynamic Asset Allocation

Dynamic asset allocation does not require a long term strategic view but adjustment of the portfolio on the basis of the long term anticipated returns. DAA starts with estimated long-term strategic asset allocation, but goes on to adjust or re-balance the mix of assets on the basis of short term changes in the returns. Re-balancing helps to maintain the original asset allocation and carry out desirable changes in investing pattern. In mutual funds the fund managers switches from one instrument to another within a given fund- mid- cap, large- cap or sectoral in equity or gilts, floaters or liquids in debt. As long as the funds are open- ended, re-balancing can be on the basis of the broad category as a whole or a sub-class. (Bhope P. Tejas, 2005).
2.3.5 Market Timing

Portfolio selection and asset allocation are important investment decisions and sources of performance, but the gain of benefits in terms of profit/income depends, to a great extent, on the timing of actions like selling, buying and switching of assets within the portfolio. In the changing market environment, the strategy of market timing is very useful because by matching decisions with the expected market movements, it helps maximize benefits. It allows the fund manager to rebalance the portfolio - he can change the relative holding of debt, equity, gilts and cash in anticipation of changes in the complexion of the market.

Therefore, an effective fund manager must be capable of identifying the signals of change in the market (bull/bear phases), as well as the business cycle phases (recession, upswing, boom and downswing), and take timely decisions to sell, buy, or switch assets in the portfolio.

2.3.6 Fund Management Style

2.3.6.1 Top-Down

This approach relies heavily on the analysis and forecasting of trends in the economy and industry. It starts with an evaluation of the expected impact of changes in the world economy on the macro economy of the country concerned. Next, the expected influence of these changes on domestic industry is evaluated and the stocks which are expected to outperform the market are identified. The expected market changes are the driving force behind this particular investment strategy.

2.3.6.2 Bottom-Up

This approach places greater emphasis on individual stock selection and is based on the assumption that the economic fundamentals are implicit in the stock prices. Fund managers following the bottom–up approach pick
up stocks which are under valued and have the potential to outperform (Sadhak H, 2003).

Fidelity Fund Management focuses only on bottom-up stock picking. Most top-down philosophies focus on macro-forecasts, geographies, countries and finally stocks. If one gets all these calls right, the impact on returns could be high. In bottom-up stock picking one is focused on stock selection through study of balance sheet, understanding the financials, meeting the company, the management, collating inputs from dealers etc (Suyash A, 2005).

2.3.6.3 Bond Portfolio Management Style

The bond portfolio management strategies can be broadly divided into two broad groups:

1) Passive Portfolio Strategies
   - Buy and Hold
   - Indexing

2) Active Management Strategies
   - Interest Rate anticipation
   - Valuation Analysis
   - Credit Analysis

Buy and Hold

In this strategy the fund manager selects a portfolio of bonds based on the objectives and constraints with the intent of holding these bonds till maturity.

Indexing

The objective is to construct a portfolio of bonds that will equal the performance of a specified bond index. A well-accepted concept internationally, bond index funds have made the entry very recently in Indian mutual fund industry with the launch of Birla Bond Index Fund. It
is India’s first bond index fund designed to track the CRISIL Composite Bond Fund Index.

**Interest Rate Appreciation**

The idea is to preserve capital when an increase in interest rate is anticipated and achieve attractive capital gains when interest rates are expected to decline. Such objectives usually are attained by altering the duration structure of the portfolio (i.e. reducing portfolio duration when the interest rates are expected to increase and increasing the portfolio duration when a decline in yields is anticipated).

**Valuation Analysis**

With valuation analysis the fund manager attempts to select bonds based on their intrinsic value. Given all the characteristics of the bond and the normal cost of the characteristics in terms of yield, the bonds implied intrinsic value can be determined. This exercise is to be done for a number of bonds. The next step is to compare these derived bond values to the prevailing market prices to determine which bonds are undervalued or overvalued. The fund manager would buy the undervalued issues and ignore or sell the over valued issues.

**Credit Analysis**

Credit analysis strategy involves detailed analysis of the bond issuer to determine expected changes in its default risk. This involves attempting to project changes in the quality rating assigned to bonds by the rating agency. These rating changes are affected by the internal changes in the issuers’ profile and by changes in the external environment (i.e. changes in the firm’s industry and the economy) (IIB&F, 2007).

**2.3.6.4 Equity Portfolio Management Style**

Depending on the approach of investment, the fund management could be either passive- as in case of index funds-or active. ‘Buy and hold’ is passive in terms of activity, but can be very dangerous in terms of
implications. The fund management could be value oriented (investing primarily in value stocks), growth oriented (investing primarily in growth stocks) or momentum oriented (investing primarily in momentum stocks). The value stocks are shares whose current valuation does not reflect some aspect of the company that could be extremely valuable. For instance, an investor who feels that the last mile connectivity that MTNL has in the two important cities of Mumbai and Delhi is not fully reflected in the price would be viewing it as a value stock. One would aim to unlock value when the market appreciates the value of last mile connectivity and pushes the stock valuation up.

Growth stocks are expected to demonstrate earnings growth that is better than the market. From time to time various promising sectors in the economy emerge, such as software during 1998-2000. Good companies in such sectors are viewed as growth stocks and attract high level of investment interest (Sankaran S, 2007).

There are some fund managers who believe in 'contrarian investing'. Most investors chase momentum and focus on rising stocks, rejecting those that fall. This causes them to overlook quality companies at low prices. This irrational behaviour provides excellent opportunities if one can detach himself from the crowd and move in the opposite direction. Contrarian investing is similar to value investing. Value investors look more at the valuations such as the P/E multiples, Price/Book Value etc. The focus is thus on value. A contrarian approach involves picking up quality stocks when the markets are ignoring them purely for temporary reasons like changes in government policy, competitive environment or the business environment (Bhope T, 2005).
**Fundamental & Technical Analysis**

Investment and disinvestment decisions are broadly taken based on either of the following two approaches:

- **Fundamental Analysis**
  
  Fundamental analysis is a study of the industry scenario, company’s financials, management, etc. collectively known as a company’s fundamentals, to determine whether the company’s stock is properly valued. If the view is that it is under valued, then the portfolio manager may choose to buy the security. If it is overvalued, the decision would be to sell the existing stock.

- **Technical Analysis**
  
  Technical Analysis is a review of the movements of the stock price in the market. A technical analyst would compare these movements with past volumes and price trends of the stock, as well as with the market movements, to form a view on whether the market or an individual stock is over-bought or over-sold, whether a stock is near a support level or resistance level and accordingly choose to sell or buy the stocks.

  Generally, fundamental analysis is seen to help decide on what action to take, namely whether to buy or sell a particular share. Having decided to take an action, when to implement the decision, the timing, could be determined by technical analysis.

  Fundamental analysis is useful for long term investments—investments made with the view that the share prices will increase many fold.

  Technical analysis is the main tool of day traders, who get in and out of stocks several times during the day to exploit small movements in the share price (Sankaran S, 2007).

  Fund houses have taken the application of quantitative models in investment decision making to a new high. Quant models use a variety of techniques, such as fuzzy logic, neural networks, genetic algorithms,
Markov models, fractal methods, and clustering techniques. Many critics argue that selecting stocks is more an art than science, not amenable to being captured in computer programs (Shashikant U, 2006).

**2.3.7 Business Cycle and Liquidity Management**

An understanding of the changes in the business cycle is very important for funds management since the business cycle represents the future changes in the economic activities. Considering that no economic activity can remain out of the business cycle, business cycle analysis forms an important component of investment decision. The changing economic/business cycle automatically influences the expected return from securities and the extent of risk. Therefore, the process of decision-making in the spheres of asset allocation, portfolio construction, market timing etc needs to incorporate the existing and expected phases of the business cycle (Sadhak H, 2003).

**2.3.8 Portfolio Protection**

Portfolio protection is a relatively new concept in portfolio management. The basic idea involves adding components (derivative securities) to a portfolio so that a floor value is established, below which the value of the portfolio will not fall.

The fund managers need to ensure compliance with the SEBI regulations regarding the use of derivatives in portfolio management. Trading in derivatives by the fund managers is restricted to Hedging and Portfolio Balancing Purposes.

The term hedging is clearly defined by the SEBI Advisory Committee on Derivative. The term hedging cover derivative market positions that are designed to offset the potential losses from existing cash market position. An income fund has a large portfolio of bonds. This portfolio stands to make losses when interest rates go up.
Hence, the fund manager may choose to short an interest rate futures product in order to offset this loss.

Portfolio Rebalancing includes all derivative strategies that enable a desired portfolio position to be achieved more effectively or at a low cost than by using cash market transactions. The underlying thumb rule is that a fund is permitted to using derivatives what it could have done directly with cash market. But the fund is not allowed to leverage beyond its size (IIB&F, 2007).

2.3.9 Portfolio Performance Measurement

2.3.9.1 Criteria-Return

Performance in the context of Mutual funds is to compare the expected return with the actual return. The most vital statistic in measuring the performance is the rate of return.

- **Holding period return vs. Compound Average Rate of Return**

  The most straightforward rate of return is the **Holding-Period-Return (HPR)**, popularly known as Total Return or Point to Point Return. It equals the income generated by an investment plus the change in price of the investment during the period the investment is held, all divided by the beginning price.

  \[
  \text{HPR} = \frac{I + (E-B)}{B}
  \]

  where

  \[
  \begin{align*}
  \text{HPR} & = \text{Holding period return} \\
  I & = \text{Income} \\
  E & = \text{Ending Price (or NAV at the time of exit) and} \\
  B & = \text{Beginning Price (or NAV at the time of entry)}
  \end{align*}
  \]

  SEBI Regulations on disclosure of information in offer documents, advertisements, etc, require that Return for periods exceeding a year is to be calculated on a Compounded Basis (except for Money Market Mutual Funds which has a short investment horizon). Compounded Annual Growth Rate expresses performance on an annual basis and by
incorporating the effect of compounding it facilitates meaningful
comparison as mutual fund is a variable- return instrument where the
holding period can exceed a year and the returns are not known at the
outset (Gajra R, 2005).

**Compounded Annual Growth Rate (CAGR)** is worked out on the
following basis:

\[
\text{CAGR} = \left( \frac{\text{Ending Value}}{\text{Beginning Value}} \right)^{\frac{1}{\text{# of years}}} - 1
\]

- **Rupee-Weighted vs. Time-Weighted Rates Of Return**

  The **Rupee-Weighted Rate of Return** is a measure of return achieved
  over a period of time by a fund with its initial investments and its
  particular cash flow. Because the RWR measures the annual rate at which
  ones cumulative contributions grow over the measurement period it
  includes the timing of new money flows.

  One can compute the **Time-Weighted Return** by first adding one to each
  year’s holding-period return to determine the return’s wealth relative.
  Then multiply the wealth relatives together, raise the product to the power
  1 divide by the number of years in the measurement period, and subtract
  1.

  RWR captures the effect of intermediate cash flows.

  TWR ignores the effect of intermediate cash flows.

- **Geometric Mean Return vs. Arithmetic Mean Return**

  The average annual **Arithmetic Return** is the simple average of
  individual total yearly returns. The yearly return is the sum of (1) the
  percentage gain (or loss) in the value of ones portfolio due to changes in
  asset prices and (2) any dividends or other cash distributions, expressed
  as the percent of invested assets.
The second method of calculating returns is **Average Annual Geometric or Compound Return**. Average Annual Geometric Return is the rate at which one's investment at the beginning of the period will accumulate to a given sum at the end of the period by the process of compounding or continuously re-investing one's dividends and capital gains.

### 2.3.9.2 Criteria- Risk

Risk is the key dimension of the performance measurement, and a decisive factor in determining a fund manager's skill. One cannot make a judgment about how skillful a manager is in a particular period by looking at return only. It refers to variability in the expected return.

- **Standard Deviation**

Standard deviation is a measure of dispersion in return. It quantifies the degree to which returns fluctuate around their average. A higher value of standard deviation means higher risk.

\[
\sigma = \sqrt{\frac{1}{N} \sum_{i=1}^{N} (X_i - \mu)^2}
\]

When used to measure the volatility of the performance of a security or a portfolio of securities, standard deviation is generally calculated for monthly returns over a specific time period—usually 36 months and to get returns on an annual basis the resulting number is then modified to produce an annualized standard deviation. Across fund categories equity funds have a higher standard deviation than balanced funds and debt-oriented funds will have a lower standard deviation (Mutual Fund Insight, 2007). This measure rewards consistency irrespective of whether gains have been made or losses. So, a mutual fund that gives negative return consistently will have a lower SD as compared to one that gives positive, but fluctuating returns (Abraham S, 2008).
• **Beta**

Market risk is measured by **Beta**. Beta relates the return of a stock on mutual fund to a market index. It reflects the sensitivity of the funds return to fluctuations in the market index.

\[
\beta_a = \frac{\text{Cov}(r_a, r_p)}{\text{Var}(r_p)}
\]

the numerator calculates Covariance between the index’s return and the mutual fund schemes’ return while the denominator evaluates Variance in the index return.

Covariance essentially measures to what extent the scheme returns and market returns move together.

A beta that is greater than one means that the fund or stock is more volatile than the benchmark index.

Beta is essentially a historic tour and does not incorporate new information. For example, a company may venture into a new business and assume a high debt level, but this new risk will not be captured by beta. Beta cannot be calculated for new funds or stocks that have insufficient history (Mutual Fund Insight, 2008).

• **R- Squared**

It measures how much of the funds return can be explained by the market movements. It does this by measuring how closely the funds performance tracks that of the benchmark index. The R- Squared of an indexed fund, investing in same securities and in the same weightage as the index will be one. The values of other funds will be lower depending upon the correlation with the benchmark index.

The Beta of a fund has to be seen in conjunction with the R- Squared for understanding the risk of the fund. If a fund has a high R- Squared, it makes the Beta a valid measure. The lower the R- Squared the less reliable is the Beta (Abraham. S, 2008).
2.3.9.3 Criteria- Risk-Adjusted Return

The differential return earned by the fund manager may be due to difference in the exposer to risk. Hence it is imperative to adjust the return for the risk.

- **Sharpe Ratio**

Risk adjusted return is called Sharpe Ratio. This ratio is named after William Sharpe. The approach is to calculate portfolio’s return in excess of the risk free return and divide the excess return by the portfolio’s standard deviation.

\[
S = \frac{E[R - R_f]}{\sigma} = \frac{E[R - R_f]}{\sqrt{\text{var}[R - R_f]}}
\]

where \( R \) is the asset return, \( R_f \) is the return on a benchmark asset, such as the risk free rate of return, \( E[R - R_f] \) is the expected value of the excess of the asset return over the benchmark return, and \( \sigma \) is the standard deviation of the asset.

A higher sharpe ratio represents a higher return generated per unit of risk. Sharpe ratio can be used to compare the performance of a number of portfolios or funds. In case of mutual funds, one can compare the sharpe ratio of a fund with that of its benchmark index.

Sharpe ratio at times can be misleading. For example, a low standard deviation can unduly influence results. A fund with low returns but with a relatively mild standard deviation can end up with a high sharpe ratio. Such a fund will have a very tranquil portfolio (Mutual Fund Insight, 2008).

- **Treynor Ratio**

The Treynor measure is computed by dividing a portfolio’s excess return, by its beta as shown in equation

\[
T = \frac{\tau_p - \tau_f}{\beta}
\]
T=the Treynor measure,
\( r_P \) = portfolio return,
\( r_t \) = riskless return and
\( \beta \) = portfolio beta.
A poorly diversified portfolio could have a high ranking on the basis of Treynor ratio and a low ranking on the basis of Sharpe ratio.

- **Jensen Alpha**

The most commonly used method of determining the return that should have been earned by the scheme at a given level of risk is by way of Alpha formulation:

\[
\alpha = (R_p - R_f) - \beta_p (R_b - R_f)
\]

\( \alpha \) = The Jensen measure (alpha),
\( R_p \) = Portfolio Return,
\( R_f \) = Riskless Return,
\( \beta_p \) = Portfolio Beta,
\( R_b \) = Benchmark Return

A negative alpha indicates that the fund is an under performer. This helps measure the ability of active management, or in other words the fund manager, to increase returns above those that are purely a reward for bearing market risks. In practice it has only limited use as funds follow different benchmarks and objectives and cannot be compared (Bhope T, 2006).

- **Appraisal Ratio**

Appraisal Ratio can be calculated by dividing alpha by the standard error of the regression:

\[
A = \frac{\alpha}{\sigma_c}
\]

A = the appraisal ratio
\( \alpha = \text{alpha and} \)
\( \sigma_c = \text{the standard error of the regression} \)
The ratio assesses the quality of fund manager’s skill.

- **Modigliani & Modigliani (M² Measure)**

It is a risk adjusted performance measure. The return a portfolio earns is called \( M² \).

\[ M² = \left( \frac{\sigma_m}{\sigma_{mf}} \right) X \left( R_{mf} - R_t \right) + R_f \]

\( \sigma_m = \text{standard deviation of the market} \)
\( \sigma_{mf} = \text{standard deviation of the scheme} \)
\( R_t = \text{Risk-free Return} \)
\( R_{mf} = \text{Return on the scheme} \)

A high (low) \( M² \) indicates that the portfolio has outperformed (underperformed) the market portfolio.

2.3.9.4 Performance Measure specific to Bond Funds

- **Duration**

Duration measure calculated is known as the Macaulay Duration, named after Fredrick Macaulay. The price sensitivity of a bond to small changes in interest rates is approximated by the bond’s duration. Duration measures the average time required for the investor to receive the investment and the interest on it. The significance of the duration is that greater the duration more volatile is the portfolio’s return in respect to changes in the level of interest rates.

\[ \text{Duration} = \sum_{t} \frac{(TxC) / (1 + r)^t}{\text{Current Bond Price}} + \frac{[(n \times M) / (1+r)^n]}{\text{Current Bond Price}} \]

\( C = \text{Semi Annual Coupon Interest Payment} \)
\( r = \text{one-half the relevant market rate of interest.} \)
\( n = \text{number of years to maturity.} \)
\( t = \text{number of semi annual coupon payments.} \)
M = Principal Value of the bond.
T = Period in which cash flow is received.

A slight variant to the Macaulay Duration is known as Modified Duration. It shows by how much the price of a bond would move if interest rates move up or down by 1 per cent (Abraham S, 2008).

The formula for it is as follows:
Modified Duration = Macaulay Duration / (1 +r)

Once the duration of a bond portfolio has been calculated then the approximate percentage price change in the bond can be determined as follows:
% change in the price of a bond portfolio = (Modified Duration)*(Change in interest rate in basis points).

The same change in interest rates affects a longer maturity debt security more than a shorter maturity debt security.

2.3.9.5 Performance Measurement of an Index Fund

Performance of an Index Fund be it debt or equity is measured by computing tracking error (TE). TE is a statistic that indicates the divergence of the return of the fund from the Index. It is calculated on the basis of past data and is usually taken as an indicator of future performance.

The reason for the existence of TE is the divergence of fund portfolio from the underlying index and the presence of transaction costs. Even if the fund portfolio exactly maps the underlying index, it should be noted that the theoretical benchmark does not have to bear the transaction costs.

2.3.9.6 Other Statistics

- Portfolio Turnover Rate

This measures the amount of buying and selling done by the fund manager. By definition, portfolio turnover is “lesser of annual purchases or annual sales, divided by the average portfolio value.” It is the weighted
average holding period of a given security. A high turnover ratio means high transaction costs.

- **Expense Ratio**

By definition expense ratio is the ratio of total expenses to average net assets. An investor can check information on a scheme’s expense ratio. Expense ratio may vary from scheme to scheme. The lowest expense ratios are observed among index funds and ETFs. Expense ratios of the schemes in different categories are to be compared. Lower expense ratios are desirable.

2.3.9.7 **Performance Evaluation**

- **Benchmarking**

Indices are used for benchmarking mutual fund portfolio. SEBI regulations require funds to specify the benchmark for the scheme in its offer document. The asset management company or the trustees of the scheme can select the benchmark. Equity funds can select from among the market indices available while debt and balanced funds need to choose Sebi specified benchmarks (Abraham S, 2008). The number and variety of available indices make selection of suitable benchmarks a daunting task. While choosing an index as benchmark for equity portfolio, the first necessity is to pinpoint the capitalization of stocks in the index. While selecting an index as the benchmark for a scheme, it is important to ensure that the capitalization of the portfolio matches with that of the index. For example in case of a fund, which largely invested in large cap stocks, it would be inappropriate to select an index, which is constructed to reflect the performance of small cap segment of the market.

The second important aspect in selecting the suitability of an index as a benchmark for a particular portfolio is the mix of stocks i.e., whether the index comprises of all growth stocks or value stocks. If the fund’s
investments style is value investing, then the appropriate benchmark would be the value stock index. While evaluating the performance of sector funds, sector indices can be used. The benchmark of a scheme can be changed at any time with the approval of the trustees.

- **Peer Group Analysis:**

Peer group analysis is simply ranking the fund manager’s performance. The term “peer group” is generally applied to a group of fund managers defined by a specific asset class or investment style.

Construction of the peer group is a tricky job. Generally a peer group is the collection of the fund managers that are investing in the similar segment of the market, i.e., equity, fixed income or a mix of both. Peer groups can be more narrowly defined on the basis of style. Examples of style peer groups include funds making investments in large capitalization stocks, small capitalization, and sector specific investing like technology stocks etc (IIB&F, 2007).

### 2.3.10 Fund Management Methods of Some Mutual Funds

#### Equity Funds:

1) **Birla Sun Life Frontline Equity Fund**

The scheme endeavours to invest in ‘frontline stocks’. These are stocks which its fund manager believes will provide superior growth opportunities.

The fund aims to maintain the same sectoral weights as BSE 200, subject to flexibility of selecting stocks within a particular sector.

The Fund suffered from lack of number of stocks and diversification in the initial years.

The Fund Manager mainly invest in equity with an increased exposure to large-cap stocks, coupled with a high allocation to debt and cash (Mutual Fund Guide 2009)
2) DSP Black Rock Equity Fund
The portfolio is substantially constituted of equity securities and equity related securities of issuers domiciled in India.
The Fund is largely invested in equity with around 20% in debt and cash. At least half the portfolio is in large-cap stocks.
The Fund manager has invested 25.41% in consumer non-durables and healthcare.
The Fund manager has gone for rigorous diversification. Number of stocks is as high as 90, while half the portfolio has an exposure to less than 1% to an individual stock.
Being an actively managed fund, a number of stocks are held for five months or less (Mutual Fund Guide 2009).

3) DWS Alpha Equity Fund
The scheme invests in companies across a range of market capitalizations with a preference for medium and large companies.
Fund manager lacked strategy in its initial years.
The portfolio averages at around 28 stocks with the top 10 holdings accounting for nearly half the portfolio (18.36% in energy sector, 13.84% in financial sector and 12.92% in FMCG sector) (Mutual Fund Guide 2009).

4) Fidelity Equity Fund
The fund aims to pursue an investment strategy including diversification, bottom-up stock picking, and no capitalization bias. The fund has the strategy that individual holdings will rarely exceed 4% of the net assets. But the fund and so the fund manager has failed to stand by its mandate and its exposure to stocks has exceeded 4% many a time, especially in the case of Reliance Industries, Bharti Airtel and State Bank of India.
The fund manager appears to prefer a portfolio that resembles the Nifty and so the top five holdings have always been from a restricted universe of just 15 stocks (Mutual Fund Guide 2009).

5) Franklin India Prima Plus

The fund aims to generate capital appreciation over the long-term by focusing on wealth creating companies—that generate return on capital in excess of their cost of capital, across all sectors.

The fund manager now mainly sticks to large caps. Though his positions in individual stocks sometimes touch almost 10 per cent, the portfolio remains basically liquid.

The small, and frequently churned, exposure to lower cap stocks, adds alpha to the fund.

Fund manager also invests in IPOs (Initial Public Offerings) (Mutual Fund Guide 2009).

6) HDFC Growth Fund

Fund manager was pretty savvy in sector selection. In 2006, while its peers were neutral towards the healthcare sector, the fund’s allocation increased from 4.44% in January to 11.33% by the end of the year. Similarly, the fund defied popular trend and pruned its allocation to financial services while increasing it to the automobile sector. In 2006 its annual return was 44.14%.

The fund manager’s style of increasing exposure to particular stock or sectors is done systematically and in a phased manner by building positions slowly.

The fund manager has capitalized on short-term opportunities and has benefited from Initial Public Offerings.

Buy and Hold has been the preferred strategy of the fund manager (Mutual Fund Guide 2009).
7) HDFC Top 200 Fund
The Fund manager is guided by the fund objective & strategy that the investment portfolio for equity and equity linked instruments will be primarily drawn from the companies in the BSE 200 Index. The fund manager is going for a predominantly large-cap portfolio consisting of blue chip stocks. Recently, there has been a more generous accommodation to mid-caps. The fund manager has invested mainly in Energy, Financial, Communication and Technology sectors (Mutual Fund Guide 2009).

8) HSBC Equity Fund
The fund follows a top-down approach before taking stock calls to benefit from market opportunities. The fund manager does a considerable stock churning. It exited construction in 2008 to re-enter a few months later but with different stock picks. It mainly invests in large-cap growth stocks. The fund manager has invested mainly in Energy, Financial, Communication and Technology sectors (Mutual Fund Guide 2009).

9) ICICI Prudential Dynamic Plan
The fund seeks to generate capital appreciation by actively investing in equity/equity related securities. For defensive considerations, it may invest in debt and money market instruments. The fund manager does not shirk away from aggressive bets. He maintains a growth portfolio and in some holdings increases the stake and exits after booking profits. The fund manager has invested mainly in Financial, Health Care, Energy and Metals (Mutual Fund Guide 2009).
10) Kotak 30
The fund aims to invest in around 30 companies which may go up to 39 companies. These companies may or may not be the same which constitute the Sensex or Nifty. While the number of stocks generally fluctuates between 30 & 39, there have been instances where it has fallen to less than 30. A natural outcome of such a portfolio is often concentrated stock holdings but the consequent lack of diversification has been taken care of by the fund manager through a tilt towards large-cap stocks. The fund manager is not an aggressive churner of stocks (Mutual Fund Guide 2009).

11) Magnum Sector Funds Umbrella-Contra Fund
The fund seeks to invest in undervalued scrips, which may be currently out of favor but are likely to show attractive growth in the long term. The fund manager generally tends to stick more with consensus sectors but shades of contrarianism do surface. The fund manager is conservative in the sense that once he takes a stance, he holds the stocks and avoids aggressive churning. The fund manager has invested in a blend of growth and value stocks. The fund manager has mainly invested in Energy, Financial, Automobile and engineering sectors (Mutual Fund Guide 2009).

12) Sahara Growth Fund
The fund seeks to invest predominantly in high growth companies and focus on large and mid cap stocks. Its aim is to build a portfolio which represents a cross-section of the strongest growth companies in each industry. In order to reduce the risk of volatility, it endeavours to diversify across major industries and sectors while avoiding needless diversification for the sake of it. The fund manager shows a penchant for large-cap stocks in his portfolio.
The fund manager moves into cash when the need arises. In fact there have been occasions where the cash allocation has even exceeded the mandated 20%.

He aggressively churns the portfolio and cashes in on opportunistic bets also (Mutual Fund Guide 2009).

13) Sundaram BNP Paribas Select Focus
The fund aims to invest in a very few select stocks. It generally holds stocks of 10 to 30 companies each with a market capitalization of not less than Rs 500 crores.

The fund manager flees to cash when the going gets tough. There have been occasions in the fund’s history when it has exceeded 25 per cent (its upper limit).

The fund manager invests aggressively in the top performing sectors and exiting them completely when the sector underperforms (Mutual Fund Guide 2009).

14) Tata Pure Equity Fund
The fund aims at medium to long term capital growth, with the assets invested in the equity of large-cap, liquid blue-chip companies. The focus is to buy into fundamentally undervalued large cap companies.

Despite the fund’s investment mandate, the fund manager has dabbled in mid-caps. During 2003 and 2004, there were times when the fund resembled a mid-cap offering.

Fund manager ensures that no individual stock allocation crosses 6% of total assets.

The fund adopts a buy-and-hold strategy; it periodically books profits when price targets have been met (Mutual Fund Guide 2009).
15) UTI Dividend Yield Fund
The fund aims to provide medium to long term capital gains and/or dividend distribution by investing in equity and equity related instruments which offer high dividend yield.
The fund manager rapidly moves in and out of sectors and boldly rides her bets.
In the recent market downturn, the fund manager has shifted towards a more conservative approach. The bold sector allocations were toned down, the number of stocks in the portfolio rose, the equity component was more tilted towards large caps and the debt and cash allocation also increased (Mutual Fund Guide 2009).

16) Franklin India Taxshield
The fund seeks to provide steady medium to long term growth of capital by maintaining a diversified portfolio of equities across sectors and market capital ranges.
The fund manager does not chase top performing sectors if he does not believe in them.
Though his fund's top 10 holdings account for almost the half the portfolio, the fund manager takes small exposure in a large number of stocks with many having an exposure of 1% or less.
The fund manager has mainly invested in FMCG, Financial, Technology and Engineering sectors (Mutual Fund Guide 2009).

17) Magnum Taxgain Scheme
The fund aims to invest 80-100 per cent of its assets in a suitably diversified portfolio of equities, cumulative convertible preference shares and fully convertible debentures and bonds.
The fund manager tends to tilt towards growth stocks but sticks largely to a buy-and-hold strategy without over looking opportunistic bets.
The fund has undergone a transformation into a more conservative offering. Most apparent has been the increased allocation to cash and debt from 2006 onwards. Simultaneously, the fund has broadened its portfolio. The fund manager has mainly invested in Energy, Financial and Engineering sectors (Mutual Fund Guide 2009).

18) Sundaram BNP Paribas Tax Saver

The scheme aims to invest in a reasonably diversified portfolio of stocks essentially meant to give higher returns in the medium to long term. A portion of the scheme's assets is invested in relatively liquid capitalization stocks. Investments are also made in IPO's; mid- and small- cap stocks and unlisted securities.

Typical of this fund’s style is flexibility in every aspect. So, it's not unusual to see it resemble a hard core mid- cap fund at one time only to later transform into a large- cap offering.

If, the fund manager sees an opportunity, he is quick to capitalize on it, be it in stocks or sectors.

But rarely does the fund manager take an exposure of more than 5% to a single stock (Mutual Fund Guide 2009).

19) Canara Robeco Balance

The fund aims to provide income as well as growth over the medium to long term by investing in equities, debt, and money market securities. The proportion of equity and equity- related investments varies between 0% and 60% with the remainder being in debt and money market.

Due to the lack of continuity in management, it’s tough to nail down this fund’s style.

There have been periods when the equity- debt allocation crossed the defined limits.

On the debt side, the fund is dabbling more in long term paper probably expecting interest rates to fall (Mutual Fund Guide 2009).
20) DSP BlackRock Balanced Fund
The fund seeks to generate long term capital appreciation and current income from a portfolio constituted of equity and equity-related securities as well as fixed income securities (debt and money market securities).
This is a fund that plays it safe.
Despite a tilt towards smaller cap stocks, it stays well balanced across sectors.
The diversification also extends to the number of stocks.
On the debt side, the fund employs all available debt instruments. It invests in a suitable combination of floating rate papers of all kinds and government bonds (Mutual Fund Guide 2009).

21) HDFC Prudence Fund
The fund seeks to generate capital appreciation along with current income from a portfolio of equity and equity related debt and money market instruments.
Despite aggressive churning on the equity side, the portfolio is well diversified across stocks and sectors.
The fund manager doesn’t get carried away by momentum plays. During the real estate boom, he stayed away from the real estate companies and invested only in infrastructure and cement stocks.
On the debt side, the fund manager prefers to hold bonds and debentures (Mutual Fund Guide 2009).

22) Magnum Balanced Fund
The fund aims to provide investors long term capital appreciation by investing in a mix of debt and equity. The scheme invests in a diversified portfolio of equities of high growth companies and balances the risk through investing the rest in a relatively safe portfolio of debt.
This fund may have toned down some its brashness but it’s still more aggressive than the normal balanced fund. It dabbles in stocks which other fund managers prefer to stay away from. On the debt side, the fund sticks to high quality paper and prefers debentures and certificates of deposits of banks and financial institutions (Mutual Fund Guide 2009).

23) Birla Sun Life MIP II Savings Plan
The fund seeks to generate regular income through fixed-income investments so as to facilitate a monthly distribution to investors. The fund primarily invests in debt and money market instruments but can also invest in equity in order to generate capital gains.

Right from the outset, the fund has maintained a very conservative approach towards interest rate risk and the average maturity of the portfolio has always been much lower than its category. This stance also extends to equity. There is no exposure to equity at all.

It’s not just equity that no longer finds a place here. Debt mutual funds, bonds and T- Bills too have been sidelined. The fund manager has invested mainly in GOI securities (Mutual Fund Guide 2009).

24) DBS Chola Monthly Income Plan
The fund’s primary objective is to generate monthly income through investments in a range of debt, equity and money market instruments. There is no assurance of a monthly distribution- it will take place only if enough returns are generated.

This fund is quite aggressive on the equity side and the fund manager does not shy away from exercising the leeway to go up to 20% in this asset class. Neither does he hesitate in taking a mid- and small- cap stock exposure. The moment the fund manager sees opportunity in equity, he pounces on it and is as quick in getting out.
On the debt side, the fund has preferred corporate debt over government securities. The fund manager has invested HDFC and TATA Sons commercial paper and HDFC and ICICI Banks debentures (Mutual Fund Guide 2009).

25) DWS Investment Opportunity Fund
The fund seeks to invest primarily in equities and for defensive consideration in a mix of equity and fixed income securities including money market instruments with the aim of generating capital appreciation over a long term.
Fund manager has displayed the ability to successfully chart his own course. The fund was a risky proposition which would attract only the boldest of investors.
Fund manager also goes with his own convictions even if they are against the consensus. In 2006, he was heavily into consumer non-durables and energy but grossly underweight in metals and engineering in comparison to his peers (Mutual Fund Guide 2009).

26) Kotak Opportunities
The fund aims to invest in a mix of large and mid cap stocks across sectors based on performance and potential of companies within the sectors.
Fund manager attempts to benefit from opportunities in the market and does not hesitate in taking concentrated sector and stock bets.
The fund manager actively churns the portfolio. It’s not surprising to see a number of stocks make an appearance for just five months or less (Mutual Fund Guide 2009).

27) Reliance Growth Fund
The fund aims to achieve long-term growth of capital by investment in equity and equity related securities through a research based investment approach.
In the initial years, it kept oscillating in its allocation to large, mid, and small caps. The fund stands out in terms of huge asset size, impressive performance and the ability to hold its own during a downside. This can be probably attributed to the aggressive cash calls (the fund has a mandate to go up to 35% into cash) coupled with diversified stock and sector allocation.

The fund manager has refrained from taking short-term opportunistic bets that he used to take in the past and he does hold on to stocks for fairly long period of time. Having said that, he is not oblivious to making a quick buck (Mutual Fund Guide 2009).

28) Reliance Regular Savings Fund- Equity Plan
The fund aims to generate consistent returns by actively investing in equity and equity related securities.

A unique aspect about this fund, but a trait common in funds from the Reliance stable, is the high cash allocations which have even crossed 30%. At times the fund manager can get quite concentrated in his stock bets, yet he has never taken huge sector bets and his portfolio is fairly diversified on that front. Having said that, he does have a tendency to go against the herd, something which has not always paid off.

A frequently churned portfolio, a tendency to go for short-term opportunistic bets, strong bias towards mid- and small- caps, and contrarians sector moves make it a bold offering (Mutual Fund Guide 2009).

29) Tata Equity P/E Fund
The fund seeks to identify under-valued companies and under normal circumstances at least 70% of the net assets would be invested in shares which have a trailing PE ratio less than that of the PE of the BSE Sensex at the time of investment.
Fund manager does not get too aggressive with his stock bets and manages a portfolio of around 50 stocks; he tends to take strong sector exposures with the top three accounting for more than half the portfolio. Mid-2008, in the midst of all the market turmoil, the fund manager took significant cash exposures and an exposure to metals that was way above the category average. These moves paid off handsomely that quarter. The fund manager may pick low PE stocks but it does not mean he will sell them when it goes up (Mutual Fund Guide 2009).

30) Franklin Infotech Fund
The fund seeks to follow an active investment strategy taking defensive/aggressive postures depending on opportunities available at various points in time. Under normal circumstances at least 65% of the total assets will be invested in the equities of the IT industry. This fund has a no-nonsense approach towards investing and is willing to wager huge bets. The number of stocks in its portfolio varies between 9 and 29. One can expect the top five stocks to corner more than 80% of the portfolio. This fund keeps a very low exposure to smaller cap stocks. Though the fund has the leeway to go up to 60% into cash, the fund manager has never succumbed to this temptation (Mutual Fund Guide 2009).

31) Tata Infrastructure Fund
The fund seeks to invest predominantly in equity and equity-related instrument of the companies in the infrastructure sector. In spite of a large-cap tilt, the number of stocks has never gone below 50. The fund manager is aggressive in his sector calls. He rapidly moves in and out of sectors and is willing to bet heavily on them (Mutual Fund Guide 2009).
Fixed Income Funds:

32) Birla Sun Life Liquid Plus
The fund seeks to generate regular income through debt and money market investments. Under normal market conditions the fund invests in fixed income securities, money market instruments, cash and cash equivalents. The investment strategy would emphasis investment in instruments that generate consistently superior yields at low levels of risk. The fund has a very specific mandate to invest only in maturity profiles between 180 and 550 days.
Most of the time the fund has taken a conservative bent when betting on the interest movement.
Commercial paper and certificate of deposits of banks play a major role in the funds’ portfolio. Among asset-backed securities, the fund has consistently maintained its exposure to papers issued by financial companies (Mutual Fund Guide 2009).

33) DBS Chola Freedom Income- Short Term Fund
The fund will invest at least 80% of its corpus in fixed income securities with the objective of generating regular and stable income for the unit holders of the Scheme. The balance will be invested in money market instruments of high quality.
At times, the fund has had to allocate most of its assets to term deposits so as to cope with the redemption pressure.
In the recent past the fund has spruced up its act. The fund manager has worked hard to minimize the risk profile. Currently its portfolio is heavyweight on debentures issued by financial institutions (Mutual Fund Guide 2009).

34) Kotak Flexi Debt
The fund aims to maximize returns through an active management of a portfolio of debt and money market securities.
The fund managers have used a whole range of debt instruments but have consistently tilted towards commercial paper, debentures and structured obligations.

The fund has the tendency of taking frequent risks opting for AA and below rated paper, which averages to around 10% of the assets every year (Mutual Fund Guide 2009).

35) Tata Floating Rate Fund- Short Term

The fund aims to generate stable returns with low risk by investing substantially in good quality floating and fixed rate debt instruments. Average maturity remains below 18 months.

Historically, the portfolio consisted mostly of P1+ rated short term instruments and AAA rated bonds.

Fund’s outlook towards interest rate risk has been on the conservative side. Except for one occasion in January 2004, it has always stuck to its mandate of not exceeding the upper limit average maturity of the portfolio. The portfolio was concentrated with debentures issued by financial sector players. Apart from that the portfolio has been in fixed rate instruments, presumably, in conjunction with swap that would convert them into synthetic floaters (Mutual Fund Guide 2009).

36) Templeton Floating Rate Income Fund- Short Term Plan

The scheme aims to provide a regular stream of income while minimizing risk arising from interest rate fluctuations by investing primarily in floating rate instruments.

By the end of 2005, the fund allocated greater amounts to commercial papers, debentures and bonds. By 2007, it moved completely out of floating rate paper and opted for fixed rate paper instead.

Among varied corporate debt instruments, the fund was bullish on bonds issued by public housing finance companies and commercial paper issued by public and private sector banks (Mutual Fund Guide 2009).
37) HSBC Floating Rate Fund- Long Term
The fund seeks to generate reasonable return with commensurate risk from a portfolio comprised of floating rate debt instruments and fixed rate debt instruments swapped for floating rate returns. The scheme also invests in fixed rate money market and debt instruments. This conservative offering has always kept its average maturity around three months, which is lower than that of its peers.

Though the fund has refrained from taking active bets on interest rates, it has managed to stay ahead of the curve.

Among the various debt instruments, structured debt features regularly in the portfolio as and when an opportunity presented itself. Since April 2007, the portfolio preference in shorter maturity paper shifted significantly from commercial paper to certificate of deposits issued by banks (Mutual Fund Guide 2009).

38) Kotak Floater Long Term
The fund aims to reduce the interest rate risk associated with investments in fixed rate instruments by investing predominantly in floating rate securities, money market instruments and using appropriate derivatives. It may also invest in offshore securities.

The portfolio of the fund has largely comprised of high quality debt paper. But at times the fund has taken risky bets.

In 2008, the fund decided to play it safe by allocating most of the assets to shorter maturity paper of less than 90 days. By holding back from taking active bets on the interest rate, the fund has resulted in a far more stable offering when compared to its peers (Mutual Fund Guide 2009).

39) Principal Floating Rate Fund- Flexible Maturity Plan
The fund aims to generate income from a portfolio comprising substantially of floating rate debt instruments, fixed rate debt instruments
swapped for floating rate return, and also fixed rate instruments and money market instruments.

The fund has kept most of its holdings in commercial paper of various financial companies. Among other instruments of its liking have been floating rate instruments and structured obligations.

Fund managers been prudent enough not to compromise on the safety of the fund in the pursuit of higher returns. The allocation in high quality paper of triple ‘A’ and P1 + was always around 80% (Mutual Fund Guide 2009).

40) IDFC Government Securities Fund- Provident Fund

The fund aims to generate optimal returns with high liquidity by investing in government securities. The fund will invest 0% - 100% of its corpus in government securities.

The small corpus actually proved to be a blessing in disguise for the fund. It has leveraged its size advantage to move in and out of any type of instrument of any maturity.

Though there is no question of the fund’s ability to perform, the fund must work on becoming more cost efficient. Its small size and frequent churning have resulted in higher than average expenses (Mutual Fund Guide 2009).

2.3.11 Fund Management- Industry Speaks

Let us discuss the opinion of India’s best mutual fund managers and wealth creators of 2008 on portfolio selection skill and timing abilities with reference to mutual fund management styles of three Equity Funds and two Debt Funds.

First’s Prashant Jain, HDFC AMC believes in investing in good quality businesses. He uses a mix of bottom-up and top-down approach identify the best companies to invest in and performance shows an average three
year return of 34.46% over four mutual fund schemes. Total corpus handled is Rs.11,577 crore.

Second, Sri Krishna Sanghvi, Kotak MF, preferred large cap and mid-cap companies and invest for growth. He preferred companies with management capabilities, and performance shows he managed 9 funds. Five of these existing for over 3 years have yielded 33.82%. Total corpus handled is Rs.3,085 crore.

Thirdly, Sri M.Venugopal, Tata AMC, tried to identify good companies ahead of others, spot trends and dependent on in-house research. He had a mix of top-down and bottoms-up approach and performance shows that he managed 16 funds with a corpus of Rs.7507 crore. 8 of these with a 3-year history have delivered 37% per annum.

Debt Fund Manager Sri Pankaj Tibrawal, Principal PNB AMC, is of opinion that his investment reflects a blend of large, mid and small cap companies. There is no market cap restriction. The focus is fully on bottom-up stock picking. Performance shows that he managed 5 debt funds with a corpus of Rs.873 crore. Average 3 year return is 25.57%. On the other hand, the debt fund manager of the Birla Sun Life AMC; Sri Satyabrata Mohanty hunted for superior risk-adjusted returns. He followed a dynamic duration strategy. Depending on the condition of debt markets, asset allocation was decided between corporate bonds and government securities. His performance shows that he manages 20 funds with assets of Rs.16952 crore. He delivered an average 3-year return of 9.11%. (Business World, 3rd March, 2008).

However, whatever the style and basis of stock selection, it is ultimately the fund manager’s ability to execute the accepted strategy and style, keeping the investment objectives in view, that has the greatest influence on the performance of the portfolio. Nowadays investors have stopped obsessing about macroeconomics and world events, and focus on the
micro issues of their own earning, spending and saving. Now, investors are worried about their jobs, increments, savings and such neglected aspects of their financial lives. Indian household sector shows a significant shift in investor’s performance from physical to financial asset. With the entry of new players in the financial markets, at present investors find several new instruments matching their varying needs and risk return perception.

Change in the economic scenario, falling interest rates on bank deposits, volatile nature of capital market and recent bitter experience of investor in making direct investment emphasizes the increasing importance of mutual funds. The emerging challenge for mutual funds managers in coming years is to convert first timer into regular Mutual Funds unit buyers. According to the Steward Aldcroft, Managing Director of Invested Asset Management Asia, the people who bought guaranteed products were mainly servers and will not have invested all their assets. So, there is a good opportunity to get more of their money invested into mutual funds. In fact, when market volatility is expected to be high, variation on the guaranteed items are likely to be winners. Therefore, many firms are banking on the non-correlated, absolute return, appeal of hedge funds even coupling that with a guarantee. (Tecnia Journal of Management Studies, Oct’07-Mar’08).

An investor of mutual funds may believe that fund managers do not make much of a difference; it is always the fund’s internal processes and risk control measures that drive the funds performance. There is no denying that fund managers have started to make a difference. It is said that if mutual fund management gives some liberty to their fund managers, they can work wonders of portfolios. Fund houses that impose strict internal controls have shown mixed results. A good example of balancing controls with freedom is HDFC MF. Despite being one of the oldest mutual funds
in India; it has been able to attract a good fund management style and team that has delivered consistent returns.

What remains ahead? As the market innovates, products will straddle regulators: SEBI, Reserve Bank of India, IRDA (Insurance Regulatory and Development Authority), FMC (Forward Markets Commission) and others. It is needed to work together in a way that encourages innovation. Increasing interaction with the world is to be seen and hence, both the regulator and the market will have to learn to be alert to all manner of international developments, which may affect whether they are liked or not. Cross-border regulatory co-operation have to be learnt since cross-border trading and commerce would only increase. Such co-operation would mean give and take of increasing magnitude and would, therefore, need different skills and much deeper understanding of the issue involved (Outlook Money, July 30th 2008).

To conclude the discussion and critical appreciation of mutual fund management style, it is to be noted that mutual fund managers generally invest only in market-traded stocks. Mutual funds are among the most active institutional investors in the stock markets. In the process of rapid economic change, the stock selection task of an active fund manager as well as mutual fund style in India is by no means simple or limited.

RESUME
Portfolio management is at the base of the mutual fund business. Fund managers carry this function. In constructing, managing and revising portfolios they are supported by many other departments of the organization.

Portfolio management process essentially involves activities like Asset allocation, Shift in weighting across major asset classes and Security
selection. Fund managers use portfolio optimizer for constructing optimal portfolios subject to their respective investment constraints.

To achieve the stated investment objectives, the fund manager may resort to either Active portfolio management or Passive portfolio management.

Buy and hold is the most obvious passive strategy but it is not a feasible strategy with bonds as they mature and needs replacement. Active management strategies with bond include adjusting the portfolio duration in accordance with an attempt to forecast interest rate changes.

An equity funds manager may choose to remain active to any (or all) of the components of risk viz, market risk, industry risk and company risk. When he remains passive to all the three components, he is managing an index fund. Equity fund managers may pursue value style or growth style or a mix of both.

There are many ways of measuring returns. The method one chooses depends on the particular performance evaluation objective.

If performance of the scheme is being evaluated from the perspective of the investors the rupee-weighted rate of return would be appropriate. On the other hand if the fund manager’s performance is evaluated one is trying not to conceal the effect of his decisions by including the impact of cash flows over which he has not much control. Then the time-weighted rate of return methodology should be used.

Investors feel more comfortable when we combine these two numbers i.e. risk and return into one.

Benchmarking and Peer Group analysis of mutual fund schemes make performance measurement and evaluation more meaningful.