CHAPTER 1

INTRODUCTION

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1.1 Origin and History of Mutual Funds

The evolution of Mutual funds can be traced to the times of the Egyptians and Phoenicians when they sold shares in caravans and vessels to spread the risk of these ventures. Historians are uncertain of the origins of investment funds; some cite the closed-end investment companies launched in the Netherlands in 1822 by King William I as the first mutual funds, while others point to a Dutch merchant named Adriaan van Ketwich whose investment trust created in 1774 may have given the king the idea. In July 1774, he offered on the market a diversified pooled security specifically designed for citizens of modest means. The security was known as a negotiatie, an instrument very similar to the present day closed-end fund. This first negotiatie, Eendragt Maakt Magt, invested in bonds issued by foreign governments and banks and in plantation loans in the West Indies. The issue was successful and van Ketwich introduced his second negotiatie, Concordia Res Parvae Crescunt in 1779, with more freedom in investment policy. The prospectus stated that the negotiatie would invest in "solid securities and those that based on decline in their price would merit speculation and could be purchased below their intrinsic values..." Concordia Res Parvae Crescunt existed for 114 years; in 1893 it was officially dissolved. During the 1780s and 1790s more than thirty negotiaties emerged to speculate on the future credit of the United States. Ketwich probably theorized that diversification would increase the appeal of investments to smaller investors with minimal capital. The name of Ketwich's fund, Eendragt Maakt Magt, translates to "unity creates strength". The next wave of near-mutual funds included an investment trust launched
in Switzerland in 1849, followed by similar vehicles created in Scotland in the 1880s (Saha, 2012).

The idea of pooling resources and spreading risk using closed-end investments soon spread in Great Britain and France, and then to the United States in the 1890s. The Boston Personal Property Trust, formed in 1893, was the first closed-end fund in the U.S. The creation of the Alexander Fund in Philadelphia in 1907 was an important step in the evolution toward what we know as the modern mutual fund. The Alexander Fund featured semi-annual issues and allowed investors to make withdrawals on demand. The creation of the Massachusetts Investors' Trust in Boston, Massachusetts, heralded the arrival of the modern mutual fund in 1924. The fund went public in 1928, eventually spawning the mutual fund firm known today as MFS Investment Management. State Street Investors' Trust was the custodian of the Massachusetts Investors' Trust. Later, State Street Investors started its own fund in 1924 with Richard Paine, Richard Saltonstall and Paul Cabot at the helm. Saltonstall was also affiliated with Scudder, Stevens and Clark, an outfit that would launch the first no-load fund in 1928 (Ferri, 2009). A momentous year in the history of the mutual fund, 1928 also saw the launch of the Wellington Fund, which was the first mutual fund to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.

By 1929, there were 19 open-ended mutual funds competing with nearly 700 closed-end funds. With the stock market crash of 1929, the dynamics began to change as highly-leveraged closed-end funds were wiped out and small open-end funds managed to survive. Government regulators also
began to take notice of the fledgling mutual fund industry. The creation of the Securities and Exchange Commission (SEC), the passage of the Securities Act of 1933 and the enactment of the Securities Exchange Act of 1934 put in place safeguards to protect investors: mutual funds were required to register with the SEC and to provide disclosure in the form of a prospectus. The Investment Company Act of 1940 put in place additional regulations that required more disclosures and sought to minimize conflicts of interest. The rules of investing in mutual funds changed significantly after the great stock market crash of 1929. The Securities & Exchange Commission (SEC) was born, and two key pieces of legislation, the Securities Act of 1933 and the Securities Exchange Act of 1934 were passed by Congress. The SEC helped create the Companies Act of 1940 and now require companies to file their financial information and provide disclosure to investors in the form of a prospectus. This means that investors are now able to judge which companies are sound, and which companies they should avoid (Das, 2009).

In the US the creation of the SEC boosted consumer confidence, and by the 1960's the mutual fund market was showing massive growth with about 270 different mutual funds. The bear market of 1969 caused some stagnation but growth in the industry later resumed. The mutual fund industry continued to expand. At the beginning of the 1950s, the number of open-end funds topped 100. In 1954, the financial markets overcame their 1929 peak, and the mutual fund industry began to grow in earnest, adding some 50 new funds over the course of the decade (Lowell, 2006). The 1960s saw the rise of aggressive growth funds, with more than 100 new funds established and billions of dollars in new asset inflows. Hundreds of
new funds were launched throughout the 1960s until the bear market of 1969 cooled the public appetite for mutual funds. Money flowed out of mutual funds as quickly as investors could redeem their shares, but the industry’s growth later resumed.

In 1971, William Fouse and John McQuown of Wells Fargo Bank established the first index fund, a concept that John Bogle further used as a foundation to build The Vanguard Group, a mutual fund powerhouse renowned for low-cost index funds. The 1970s also saw the rise of the no-load fund. This new way of doing business had an enormous impact on the way mutual funds were sold and would make a major contribution to the industry's success. With the 1980s and ‘90s markets became bullish and previously obscure fund managers became superstars, the mutual fund industry's top fund managers, became household names and money poured into the retail investment

By 2002, with the burst of the technology bubble and scandals involving big Fund managers, the Mutual Fund Industry lost much of its shine and reputation. Shady dealings at major fund companies clearly proved that mutual funds weren’t always benign investments managed by fund managers who had their shareholders' best interests in mind. But despite the 2003 mutual fund scandals and the global financial crisis of 2008-2009, mutual funds industry is still very upcoming and growing. In the U.S. alone there are more than 10,000 mutual funds, and if one accounts for all share classes of similar funds, fund holdings are measured in the trillions of dollars. This represents approximately 83 million investors and makes mutual funds one of the most popular forms of investing in the US. Despite
the launch of separate accounts, exchange-traded funds and other competing products, the mutual fund industry is still competitive and fund ownership continues to grow. The world leader in mutual funds, the US industry manages USD 13 trillion, accounts for 57 percent of global assets. An impressive 44 percent of American households own mutual funds with defined contribution plans making up one-tenth of US households aggregate financial assets. (http://m.moneycontrol.com/news/mf-news/how-does-indian-mutual-fund-industry-compareglobal-peers).

1.1.1 History of Mutual Funds in UK

In UK, the concept of investment trust gained momentum in the eighteenth century. The first investment trust “the foreign and colonial investment trust” was founded in London in 1868. Later in 1873 the Scottish American trust was established by Robert Flemming at Dundee. At that time, British bonds were selling as foreign government bonds for 5-6 percent. Today with an 81 percent share, institutional clients account for a major share of the UK fund market. UK’s asset management firms earned combined revenue of USD 17 billion in 2011 on an AUM of USD 1.02 trillion. The main distribution channels are private banks, retail banks, fund supermarkets and IFAs. Unlike the rest of Europe where many AMCs are controlled by banks, in UK only 18 percent AMCs are owned by banking groups while insurance firms control 17 percent and 65 percent are independent. (http://www.moneycontrol.com/news/mf-news/how-does-indian-mutual-fund-industry-compareglobal-peers).
1.1.2 History of Mutual Funds in Canada

The first Canadian fund, Canadian Investment Fund Ltd. (CIF), was established in 1932, with assets of $51 million in 1951. It changed its name to Spectrum United Canadian Investment Fund in Nov 1996 and this fund changed name at the end of August 2002 to CI Canadian Investment Fund. The growth of mutual funds and their impact on investing in general was nothing short of revolutionary. For the first time, ordinary investors with minimal capital could pool their resources into a professionally managed, diversified basket of investments, rather than going the more expensive route of buying individual stocks of varying risks. This was considered a giant step in the democratization of investments for the average person.

The first major sign of growth and popularity of mutual funds in Canada took place in the early 1960’s when total assets doubled from $540 million in 1960 to more than $1 billion by the end of 1963. To meet the growing regulatory and trade needs of the mutual fund industry, the Canadian Mutual Funds Association was established in 1962. Original members of the CMFA were individual mutual funds themselves, and not fund management companies, as is the case currently. In April, 1963, the CMFA published a Code of Ethics and Regulation for its members. Ten years later, it formally incorporated with a mandate to engage in and support activities conducive to high ethical standards and efficiency of administration and operations within the Canadian mutual fund industry. In 1976, the CMFA changed its name to The Investment Funds Institute of Canada (IFIC).
But the largest influx into mutual funds in Canada came during the 1990s when double-digit interest rates that had lured Canadian savers into GICs tumbled and investors moved into investments with the potential for higher returns. The growth of mutual funds and their impact on investing in general was nothing short of revolutionary. For the first time, ordinary investors with minimal capital could pool their resources into a professionally managed, diversified basket of investments, rather than going the more expensive route of buying individual stocks of varying risks. This was considered a giant step in the democratization of investments for the average person.

Interest rates and mutual fund sales had a direct correlation in the 1990s. In May 1990, the Bank of Canada rate – on which financial institutions base their interest rates – stood at one of its highest levels ever -- 14.05 per cent. The Bank rate steadily declined and by January 1993, was sliced in half at 6.81 per cent and by the end of December 1993 it was down again to 4.11 per cent. Mutual fund sales surged 140 per cent from the end of 1992 to the end of 1993 and strong markets sent assets up to almost $114.6 billion. The Bank rate dropped to 3.25 per cent in January 1997 before slowly climbing to five per cent in January 2000. At the same time, mutual funds continued their climb and became the fastest-growing segment of the Canadian financial services sector during the 1990s, with assets under management increasing from $25 billion in December 1990 to $426 billion by December 2001, an increase of 1,700 per cent. These assets were managed in about 1,800 different mutual funds held in more than 50 million unit holder accounts (www.ific.ca).
Graph 1.1: Mutual Funds Asset Under Management in Canada

Canada’s 80-year-old mutual fund industry manages USD 834 billion as on 31st March 2013. There are around 150 mutual fund firms in Canada employing more than 90,000 people. Mutual funds and mutual fund wraps account for nearly 30 percent of Canada’s financial wealth. Much like what has been recommended by SEBI recently, Mutual Fund Dealers Association is the self-regulatory organisation (SRO) that regulates mutual fund dealers. A majority of Canadian advisors earn from trail fees with some advisors charging a flat percentage fee, irrespective of asset size. (http://cafemutual.com/News/InnerNews.aspx?srno=1003&MainType=New &NewsType=Industry&id=21)
1.1.3 History of Mutual Funds in Pakistan

Mutual Fund industry in Pakistan has its origin in 1962 when Government of Pakistan established NITL which launched first Open End Equity Fund in Pakistan – NIT (www.nit.com.pk/). In 1966 Government of Pakistan established ICP which launched series of Closed End Funds (25). Only in the mid 90s, the sprouts of mutual funds were witnessed. In 1994-95 more funds were launched in private sector. In 2006 total numbers of AMCs were 30 managing 56 mutual funds. Mutual Funds are one of the fastest growing sectors but as compared to over all mutual fund industry, it is at infancy stage of growth and development. The wider acceptance of equity funds by Shariah Scholars in early 1990s paved the way to launch Islamic mutual funds. As on December 2012 there are approximately 250 Islamic Institutions in some 75 countries, managing funds worth over USD $200 billion. With an Asset under management (AUM) of USD 2.6 billion which is less than 1 percent of Pakistan’s GDP, the Pakistani mutual fund industry has great scope to prosper. Low savings rate has been an impediment to the growth of the economy and the mutual fund industry. The industry is dominated by institutional investors with investor accounts being less than two lakhs. Though the industry grew rapidly from 2001-2007, the financial crisis has nearly halved the industry’s AUM. (http://moneycontrol .com/news/mf-news/how-does-indian-mutual-fund-industry-compareglobal-peers_798646.html?page=5)
1.1.4 History of Mutual Funds in India

In India, the mutual fund concept took shape only in the sixties, after a century-old history elsewhere in the world. Reacting to the needs for a more active mobilization of household savings to provide investible resources to the industry, the RBI was entrusted to create a special Institution. This was done with the setting up and enactment of the Unit trust of India (UTI) by framing an act titled the UTI Act 1963 to operate both as a financial Institution and an investment trust. The primary objective at that time was to attract the small investors and it was made possible through the collective efforts of the Government of India and the Reserve Bank of India. The history of mutual fund industry in India is divided into following phases:

Phase 1. Establishment and Growth of Unit Trust of India - 1964-87

Unit Trust of India enjoyed complete monopoly when it was established in the year 1963 by an act of Parliament. UTI was set up by the Reserve Bank of India and it continued to operate under the regulatory control of the RBI until the two were de-linked in 1978 and the entire control was transferred in the hands of Industrial Development Bank of India (IDBI). UTI launched its first scheme in 1964, named as Unit Scheme 1964 (US-64), which attracted the largest number of investors in any single investment scheme over the years. UTI launched more innovative schemes in 1970s and 80s to suit the needs of different investors. It launched ULIP in 1971, six more schemes between 1981-84, Children's Gift Growth Fund and India Fund (India's first offshore fund) in 1986, Mastershare (India's first equity
diversified scheme) in 1987 and Monthly Income Schemes (offering assured returns) during 1990s. By the end of 1987, UTI's assets under management grew ten times to Rs 6700 crores.

Phase II. Entry of Public Sector Funds - 1987-1993

The Indian mutual fund industry witnessed a number of public sector players entering the market in the year 1987. In November 1987, SBI Mutual Fund from the State Bank of India became the first non-UTI mutual fund in India. SBI Mutual Fund was later followed by Canbank Mutual Fund, LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. By 1993, the assets under management of the industry increased seven times to Rs. 47,004 crores. However, UTI remained to be the leader with about 80 percent market share.

Table 1.1: Asset Mobilization in UTI/Public Sector

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

Source:(http://www.amfiindia.com/research-information/mf-history)
Phase III. Emergence of Private Sector Funds - 1993-96

The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian promoters) to enter the mutual fund industry in 1993, provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor-servicing technology. By 1994-95, about 11 private sector funds had launched their schemes.

Phase IV. Growth and SEBI Regulation - 1996-2004

The mutual fund industry witnessed robust growth and stricter regulation from the SEBI after the year 1996. The mobilisation of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds. Investors’ interests were safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. The Union Budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various Investor Awareness Programmes were launched during this phase, both by SEBI and AMFI, with an objective to educate investors and make them informed about the mutual fund industry. In February 2003, the UTI Act was repealed and UTI was stripped of its Special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. UTI was re-organized into two parts: 1. The Specified Undertaking, and 2. The UTI Mutual Fund. Presently Unit Trust of
India operates under the name of UTI Mutual Fund and its past schemes (like US-64, Assured Return Schemes) are being gradually wound up. However, UTI Mutual Fund is still the largest player in the industry. In 1999, there was a significant growth in mobilisation of funds from investors and assets under management.

Table 1.2: Fund Mobilisation from 1998-2005

<table>
<thead>
<tr>
<th>FROM</th>
<th>TO</th>
<th>UTI</th>
<th>PUBLIC SECTOR</th>
<th>PRIVATE SECTOR</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>01-April-98</td>
<td>31-March-99</td>
<td>11,679</td>
<td>1,732</td>
<td>7,966</td>
<td>21,377</td>
</tr>
<tr>
<td>01-April-99</td>
<td>31-March-00</td>
<td>13,536</td>
<td>4,039</td>
<td>42,173</td>
<td>59,748</td>
</tr>
<tr>
<td>01-April-00</td>
<td>31-March-01</td>
<td>12,413</td>
<td>6,192</td>
<td>74,352</td>
<td>92,957</td>
</tr>
<tr>
<td>01-April-01</td>
<td>31-March-02</td>
<td>4,643</td>
<td>13,613</td>
<td>1,46,267</td>
<td>1,64,523</td>
</tr>
<tr>
<td>01-April-02</td>
<td>31-Jan-03</td>
<td>5,505</td>
<td>22,923</td>
<td>2,20,551</td>
<td>2,48,979</td>
</tr>
<tr>
<td>01-Feb.-03</td>
<td>31-March-03</td>
<td>*</td>
<td>7,259*</td>
<td>58,435</td>
<td>65,694</td>
</tr>
<tr>
<td>01-April-03</td>
<td>31-March-04</td>
<td>-</td>
<td>68,558</td>
<td>5,21,632</td>
<td>5,90,190</td>
</tr>
<tr>
<td>01-April-04</td>
<td>31-March-05</td>
<td>-</td>
<td>1,03,246</td>
<td>7,36,416</td>
<td>8,39,662</td>
</tr>
<tr>
<td>01-April-05</td>
<td>31-March-06</td>
<td>-</td>
<td>1,83,446</td>
<td>9,14,712</td>
<td>10,98,158</td>
</tr>
</tbody>
</table>

Source: www.mutualfundsindia.com
Phase V. Growth and Consolidation - 2004 Onwards

The industry has also witnessed several mergers and acquisitions recently, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players.

Graph 1.2: Growth in Assets Under Management in India

Source: www.amfiindia.com
1.2 Mutual Funds- Definition and Concept:

Mutual fund is an institutional arrangement which mobilizes savings of million of investors for investment in diversified portfolio of securities with a view to spreading risk and ensuring adequate and consistent return both in the form of dividend and capital appreciation. It is a financial intermediary which receives money from shareholders, invests it, earns on it, and makes it grow to share it with them. These institutions are managed by professional fund managers who make portfolio investment decisions on behalf of unsophisticated investors’. Mutual funds play a vital role in resource mobilization and their efficient allocation. Throughout the world these funds have played a significant role in financial intermediation, development of capital markets and growth of the corporate sector as a whole. The active involvement of mutual funds in economic development can be seen by their dominant presence in the money and capital markets world over. Their presence is, however, comparatively stronger in the economically advanced countries. Mutual funds as efficient allocators of resources have played a vital role in transitional economy like India (Chander, 2000). The growing importance of Indian mutual funds is clearly visible in terms of the increased mobilization of funds and the increasing number of schemes and investors in the industry. The Indian capital market has witnessed unprecedented developments and innovations. One such development is the increasing role, which the mutual fund industry is playing in financial intermediation, development of capital markets and growth of corporate sector (Gupta, 2001).
Mutual Funds, an investment company is a financial intermediary which collects savings of the individuals or institutions and channelises these savings essentially in corporate securities in such a manner as to ensure its investors benefits of steady return and capital appreciation along with low risk. In a mutual fund there are three entities operating. They are: (i) An agency, which mobilizes savings and get a commission (ii) An investment agency, which gets a prescribed rate of commission and (iii) A trustee institution, which is normally a bank which holds the stock of securities of the mutual fund (Tripathy, 2007). In India, the investment trusts are established according to the provisions of the Indian Companies Act. Mutual funds have been defined by various authors in different ways.

Some authors have defined mutual funds as a means of building internal equity. As per Pierce (1984), a mutual fund is a non-depository or non-banking financial intermediary, which acts as an important vehicle for bringing wealth holders and deficit units together indirectly. The VNR Dictionary of Business and Finance defines mutual funds as “An investment fund that pools the invested funds of others and invests these funds on their behalf, usually in a specific kind of investment, such as money market instruments, municipal bonds or common stock”. SEBI (Mutual Funds) Regulations 1993 defines a Mutual Fund as, a fund established in the form of trust by a sponsor to raise money by the trustee through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations. While there is no legal definition of mutual fund, the term is most commonly applied only to those collective investment schemes that are regulated, available to the general public and open-ended in nature. In the words of Ross (1988), a
mutual fund means taking the pool of money and investing it in the securities of a wide range of companies. Managers of mutual funds decide when to buy, sell or hold in order to achieve the objective of the fund.”

From the above definitions it can be understood that mutual fund is a financial intermediary established in a form of trust sponsored by banks, financial companies, and other industrial concerns with an objective to mobilize savings (mostly household) by launching various schemes and investing the pooled savings in various instruments of capital and money markets. Internationally, mutual funds in the US are synonymous with unit trusts in the UK. The definition provided by Encyclopedia Britannica adds clarity to the concept of mutual fund and unit trust. “Mutual fund- also called unit trust or open ended trust- a company that invests the fund of its subscribers in diversified securities and in turn issues units representing shares in those holdings. It differs from the Investment trust, which issues shares in its own capital. In contrast to closed-ended investment companies, which have a fixed capitalization and whose shares are brought and sold in the market, mutual funds make continuous offering of new shares at net asset value and redeem the shares on demand at net asset value determined daily by the market value of the securities they hold.”

Some authors have highlighted its use as an instrument to reduce risk by diversification. Weston and Brigham (1996) in their book Essential of Managerial Finance define mutual Funds as corporations which accept dollars to buy stocks, long term bonds, short term debt instruments issued by business or government units, these corporations pool funds and thus,
reduce risk by diversification. Some authors highlight the mutual fund its essential feature of bringing good returns to the shareholders. As per Mutual Fund Factbook (1995), A mutual fund is a financial service organization that receives money from shareholders invests it, earns return on it, attempts to make it grow and agrees to pay the shareholders cash on demand for the current value of his investment.

1.3 Types of Mutual Fund Schemes in India

Wide variety of Mutual Fund Schemes exists to cater to the needs such as financial position, risk tolerance and return expectations etc. Thus, mutual funds have variety of types (Northcott, 2009). There are over hundreds of mutual funds scheme to choose from. However, by categories mutual funds can be subdivided as follows

**BY STRUCTURE**- The first type of mutual funds in this category are called open ended funds. An open-ended fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices. The key feature of open-end schemes is liquidity. The second type is that of Close - Ended Schemes. These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of
demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor. The third type is that of Interval Schemes. Interval Schemes are those schemes, which combine the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

**BY NATURE**-The first type of mutual funds here are called Equity funds. These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may be different for different schemes and the fund manager’s outlook on different stocks may vary. The Equity Funds are sub-classified depending upon their investment objective, as follows: Diversified Equity Funds, Mid-Cap Funds, Sector Specific Funds and Tax Savings Funds (ELSS). Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix. The second type of funds is that of Debt funds. The objective of these funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. Debt funds are further sub-classified into four categories.
Gilt Funds invest their corpus in securities issued by Government, popularly known as Government of India debt papers. These Funds carry zero default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government. Income Funds invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities. Monthly income plans (MIP) invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes. Short Term Plans (STPs) are meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

Finally Liquid Funds are there which are also known as Money Market Schemes, These funds provide easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds. The midway between equity fund and debt funds are Balanced funds. As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity
part provides growth and the debt part provides stability in returns (Tyson, 2011).

Further the mutual funds can be broadly classified on the basis of investment parameter that is each category of funds is backed by an investment philosophy, which is pre-defined in the objectives of the fund. The investor can align his own investment needs with the funds objective and invest accordingly. Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited. Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).

Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money (Benz, 2003).

Other schemes include Tax Saving Schemes which offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec.88 of the Income Tax Act, contributions made to any Equity Linked Savings Scheme (ELSS) are eligible for rebate Index Schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will
be identical to the stocks index weightage and hence, the returns from such schemes would be more or less equivalent to those of the Index. Sector Specific Schemes are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents like Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time. On the basis of geographical classification, mutual funds schemes can be classified as domestic and off-shore mutual funds. Domestic mutual funds schemes mobilize the savings of the country’s citizens. However, NRIs and foreign investors can invest in these schemes. All the schemes in vogue in the country are domestic mutual fund schemes. Off-shore mutual funds enable NRIs and international investors to participate in the Indian capital market. Further these funds are governed by the rules and procedures laid down for the purpose of approving and monitoring their performance by the department of economic affairs, Ministry of finance and the directions of RBI (Tripathy, 2007).

1.4 Benefits of Investing in Mutual Funds:

There are a lot of advantages of investing in mutual funds. The first and foremost is professional management. The basic advantage of funds is that, they are professional managed, by well qualified professionals. Investors purchase funds because they do not have the time or the
expertise to manage their own portfolio. A mutual fund is considered to be relatively less expensive way to make and monitor their investments. The second advantage is diversification. Purchasing units in a mutual fund instead of buying individual stocks or bonds, the investors' risk is spread out and minimized up to a certain extent. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others. Mutual funds also provide Economies of Scale. They buy and sell large amounts of securities at a time, thus help to reducing transaction costs, and help to bring down the average cost of the unit for their investors. Mutual funds provide liquidity also. Just like an individual stock, mutual fund also allows investors to liquidate their holdings as and when they want. Investing in them is easy and simple. Investments in mutual fund are considered to be easy, as compared to other available instruments in the market, and the minimum investment is small. Most AMC also have automatic purchase plans whereby as little as Rs. 2000, where SIP start with just Rs.50 per month basis. They have a good return potential. 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. Mutual funds provide transparency through regular information on the value of their investment in addition to disclosure on the specific investment made by the scheme and, the proportion invested in each type of security and the fund manager’s investment strategy and outlook. They are flexible enough through features such as regular investment plans, regular withdrawal plans and dividend reinvestment plans, investors can systematically invest or withdraw funds according to their needs and convenience. Mutual funds provide variety of choice of schemes to enable investors to take advantage of opportunities
not only in the equity, debt and money markets, but also in specific sectors. Finally, they are bound by government regulations. All 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 (Tripathy, 2007).

1.5 Limitations of Investing in Mutual Funds:
Mutual funds like any investment option also have some limitations. The primary issue is that of professional management. Some funds don't perform in any of the market, as their management is not dynamic enough to explore the available opportunity in the market, thus, many investors debate over whether or not the so-called professionals are any better than mutual fund or investor him self, for picking up stocks. The second issue is that of costs. The biggest source of AMC income is generally from the entry and exit load which they charge from investors, at the time of purchase. The mutual fund industries are thus, charging extra cost under layers of jargon. Yet another argument against mutual funds is that of dilution - Because funds have small holdings across different companies, high returns from a few investments often doesn't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money. Lastly, when making decisions about investors money, fund managers don't consider their personal tax situation. For example, when a fund manager sells a security, a capital-gain tax is triggered, which affects how profitable
the individual is from the sale. It might have been more advantageous for the individual to defer the capital gains liability (Tripathy, 2007).

### 1.6 Mutual Fund Industry in India

The Indian mutual fund Industry has evolved from a single player monopoly in 1964 to a fast growing competitive market on the back of a strong regulatory framework.

**Table 1.3: Mutual Fund Data for the Month Jan, 2013**

#### Amount in Rs. Crores

<table>
<thead>
<tr>
<th>Category</th>
<th>No. of new schemes launched during the month</th>
<th>Sales</th>
<th>Redemption</th>
<th>Asset Under Management</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>New schemes</td>
<td>Existing schemes</td>
<td>Total</td>
<td>Total</td>
</tr>
<tr>
<td>B Bank Sponsored</td>
<td>0</td>
<td>0</td>
<td>155364</td>
<td>155364</td>
</tr>
<tr>
<td>C Institutions</td>
<td>2</td>
<td>221</td>
<td>7627</td>
<td>7848</td>
</tr>
<tr>
<td>D Private Sector &amp; Joint Venture:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indian Predominantly Indian</td>
<td>8</td>
<td>2071</td>
<td>23061</td>
<td>25132</td>
</tr>
<tr>
<td>Predominantly Foreign</td>
<td>14</td>
<td>1972</td>
<td>260057</td>
<td>262029</td>
</tr>
<tr>
<td>Predominantly Foreign</td>
<td>2</td>
<td>945</td>
<td>0</td>
<td>945</td>
</tr>
<tr>
<td>Grand Total (B+C+D)</td>
<td>26</td>
<td>5209</td>
<td>446109</td>
<td>451318</td>
</tr>
</tbody>
</table>

1.6.1 The Indian Mutual Fund Industry – Key Characteristics

**AUM Growth**-The Indian mutual fund industry has grown significantly since the launch of economic reforms in the early 1990s. It took off in 2003/04, coinciding with the strong growth of the economy and capital markets. Total assets under management (AUM) have grown at a compound annual rate of 20 per cent. But growth peaked in 2009/10, and the AUM has since declined. Graph 3 shows the path of AUM and Sensex which have risen in tandem. Booming markets in 2006 saw increased investor participation in the industry, leading to fund inflows enabling the AUM to grow at a pace greater than the Sensex. However, volatile market conditions in the year 2011/12, led to net withdrawals by investors to the tune of 49,406 crore INR in FY 2010-11 and 22,023 crore INR in FY 2011-12, leading to a further drop in AUM, in addition to the drop caused by adverse market movements (Sankaran, 2012)

Graph 3: AUM evolution of the Indian Mutual Fund Industry

1.6.2 AUM Base and Growth Relative to the Global Industry

**AUM to GDP Ratio**-The increase in the size of the Indian mutual fund industry as a percentage of nominal GDP has been substantial. However, a global comparison using AUM figures from the Investment Company Institute (and from the Securities and Exchange Board of India for domestic data) and World Bank figures for nominal GDP shows that India has plenty of scope for growth. India's mutual fund industry is only eight percent of GDP. Australia's is 105 percent, the US's is 77 percent, and France's 50 percent. Brazil's is approximately 40 per cent of GDP and the sixth largest in the world. China and Russia lag behind India.

**Share of Mutual Funds in Household Financial Savings**-Investment in mutual funds in India comprised 3.3 percent of the gross household financials savings in FY 2010, which later shrunked to -1.2 percent in FY11 and -1.1 percent in FY12 due to large redemption and capital costs. As per the NCAER Survey 2011 titled “how households save and invest”, the households in India continue to hold 46 percent of their savings in fixed deposits with banks, 17 percent in insurance and 9.9 percent in currency as of FY 2011. In 2008, the UK had more than thrice the investments into mutual funds as a factor of total household savings (26 percent), than India had in the same time period.

**AUM Distribution**-As per PWC Report 2012, AUM distribution in India shows a heavy skew (approximately 50 per cent) in favour of income- and debt-oriented schemes, which are short-term investments. Growth and equity schemes account for 31 per cent of total AUM, and balanced
account for merely 3 percent and exchange traded funds account for 1.7%. As in the past, increased equity participation is the very much required.

Graph 4:AUM split between fund types as on March 31\textsuperscript{st} 2012

![Graph showing AUM split]


1.6.3 Growth and Profitability- The period from 2006 to 2012 saw a number of major events, including the global meltdown in the banking and financial services industry (BFSI), which had adverse effects on almost all business sectors. The Sensex rose from the levels of 14,000 in February 2007 to a peak of 21,000 in a span of a year (January 2008) and then plunged to levels below 9,000 in the next year (March 2009). This was despite the fact that the GDP grew by 9.3 percent in FY 2007-08 and 6.8 percent in FY 2008-09. Since then, the market has largely been in the range of 15,000 to 17,000, due to the prevalent global and local geopolitical uncertainties. Regardless of all the above factors, the Indian asset management industry achieved an absolute growth of over 50% (31 March
2007 to 31 March 2009), which is no mean feat. Over the same period, many mutual fund schemes actually delivered a positive alpha.

Since 2009/10, the industry has faced big challenges because of the global domestic economic scenario and regulatory changes. Net redemptions (outflows) were Rs. 49,405 crore in 2010/11 and Rs 22,023 crore in 2011/12. Assets under management have been concentrated in short-term liquid or money market and assured returns schemes, which, because of tax arbitrages, are used to temporarily park corporate funds. The distribution structure is also under stress due to the abolition of entry load. Transparency mandated by the regulator has been a major growth driver in the past decade. This would have helped growth, but regulatory overemphasis on protecting the retail investor has left product manufacturers struggling and the distribution system with no incentive to sell. The mutual fund industry has witnessed several reforms in the last two decades. These have helped it expand. But lately, reforms have focused more on investor protection than on taking a balanced view of the institution, issuer, intermediary, investor and instruments. Reforms that focus on structural deficiencies, distribution incentives and a tax structure that encourages retail investment will help the industry grow in the long term. (https://www.pwc.in/en_IN/in/assets/pdfs/publications/2013/indian-mutual-fund-industry-fv.pdf).

The increase in revenue and profitability in the Indian mutual fund industry has not been commensurate with the AUM growth in the last 5 years. The AUM grew at 35 percent CAGR in the period from March 2005 to 2009, while the profitability of AMCs which is defined as PBT as a percentage of
the AUM – declined from 24 Bps in FY 2004 to 14 bps in FY 2008. During FY 2004 and FY 2008, the investment management fee as a percent of average AUM was in the range of 55 to 58 bps (small increase to 64 bps in FY 2006) due to the industry focus on the underlying asset mix comprising relatively low margin products being targeted at the institutional segment (https://www.pwc.in/en_IN/in/assets/pdfs/publications/2013/indian-mutual-fund-industry-fv.pdf)

**AUM Distribution by Geography**-Distribution is skewed and shrinking. In March 2012, there were 84,793 mutual fund distributors certified by the Association of Mutual Funds in India. Of these, 78,282 were individuals and 6,511 were corporate distributors. The number was 114,000 on June 30, 2010. About 77 per cent of distributors are in just 10 cities. There is a need to rationalise the incentive structure so that distribution can spread to smaller centres. The large number of corporate investors contributing to the skew towards the debt-oriented or non-equity AuM is mirrored by the disproportionate contribution from Mumbai. The top five cities (Mumbai, New Delhi, Bangalore, Kolkata and Chennai) contribute over 71% of the total AuM, with Mumbai alone accounting for more than 42%. (https://www.pwc.in/en_IN/in/assets/pdfs/publications/2013/indian-mutual-fund-industry-fv.pdf)
The statistical analysis throws up a few more facts. Over 43 percent of the AuM is from corporate investors. Over 90 percent of corporate investor funds are invested in non-equity schemes. Almost 85 percent of corporate investors keep their funds in schemes for less than 12 months. As on March 31, 2010 there are a total number of 4.77 crores investors accounts holding units of Rs. 616,966.72 crores. Out of this total number of investors accounts, 4.63 crores are individual investors accounts, accounting for 97.07 percent of the total number of investors accounts and contribute Rs. 2,45,390.28 crores which is 39.77 percent of the total net assets. Corporate and institutions who form only 0.95 percent of the total number of investors accounts in the mutual funds industry, contribute a sizeable amount of Rs.
337,812.58 crores which is 54.75 percent of the total net assets in the mutual funds industry. The NRIs and FIIs constitute a very small percentage of investors accounts (1.98 percent) and contribute Rs. 33,763.85 crores (5.47 percent) of net assets.

Table No:1.4- UnitHolding pattern of Mutual Funds Industry (as on March 31st, 2010)

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>NUMBER OF INVESTORS ACCOUNTS</th>
<th>Percent TO TOTAL INVESTORS ACCOUNTS</th>
<th>NET ASSETS (RS.CRORE)</th>
<th>Percent TO TOTAL NET ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>46,327,683</td>
<td>97.07 percent</td>
<td>245,390.28</td>
<td>39.77 percent</td>
</tr>
<tr>
<td>NRIs</td>
<td>943,482</td>
<td>1.98 percent</td>
<td>27,428.86</td>
<td>4.45 percent</td>
</tr>
<tr>
<td>FIIs</td>
<td>216</td>
<td>0.00 percent</td>
<td>6,335.00</td>
<td>1.03 percent</td>
</tr>
<tr>
<td>Corporates/Institutions/Others</td>
<td>452,330</td>
<td>0.95 percent</td>
<td>337,812.58</td>
<td>54.75 percent</td>
</tr>
<tr>
<td>TOTAL</td>
<td>47,723,711</td>
<td>100.00 percent</td>
<td>616,966.72</td>
<td>100.00 percent</td>
</tr>
</tbody>
</table>

Source: www.sebi.gov.in/mf/unithold.html
AUM Mix by Investor Type

Graph 6: AUM Mix by Investor Type as on 31st March 2012

![AUM Mix by Investor Type](source)

27.4 percent Retail
43.1 percent Corporates
26.6 percent High net-worth individuals
2.3 percent Banks and FIs
0.7 percent FIIs


Customers

The Indian mutual fund industry has significantly high ownership from the institutional investors. Retail investors comprising 96.86 percent in number terms held approximately 37 percent of the total industry AUM as at the end of March 2008, significantly lower than the retail participation in the US at 82 percent of AUM as at December 2008.
Graph 7: AUM Mix of Investment by Investor Type (31st March 2012)

Graph 8: AUM Ageing of Retail Folios as on 31st March 2012

- 3.29% <1 month
- 57.29% > 24 months
- 4.60% 1-3 months
- 5.64% 3-6 months
- 10.53% 6-12 months
- 18.65% 12-24 months


Graph 9: AUM Ageing of Corporate Folios as on 31st March 2012

- 6.90% > 24 months
- 8.45% 6-12 months
- 12.80% 3-6 months
- 17.92% 1-3 months
- 42.58% <1 month

Indian Mutual Fund Industry-Industry Investor Mix- Out of a total population of 1.15 billion, the total number of mutual fund investor accounts in India as of 31 March 2008 was 42 million (the actual number of investors multiple folios). In the US, an estimated 92 million individual investors owned mutual fund out of a total population of 305 million in 2008. As per the Invest India Incomes and Savings Survey 2007 of individual wage earners in the age group 18 to 59 years conducted by IIMS Dataworks, only 1.6 percent invested in mutual funds. Ninety percent of the savers interviewed were not aware of mutual funds or of investing in mutual funds through a Systematic Investment Plan (SIP). The mutual fund penetration amongst the paid Indian workforce with annual Household income less than INR 90,000 was 0.1 percent. In the last few years, the retail investor participation, in particular, in Tier 2 and Tier 3 towns, has been on the rise aided by the buoyant equity markets.

Products- The Indian mutual fund industry is in a relatively nascent stage in terms of its product offerings, and tends to compete with products offered by the Government providing fixed guaranteed returns. As of December 2008, the total number of mutual fund Schemes was 1,002 in comparison to 10,349 funds in The US. Debt products dominate the product mix and comprised 49 percent of the total industry AUM as of FY 2009, while the equity and liquid funds comprised 26 percent and 22 percent respectively. Open-ended Funds comprised 99 percent of the total industry AUM as of March 2009. As of December 2008, the US mutual fund market comprised money market funds, equity funds, debt/ Bond funds and hybrid funds at 40, 39, 16 and 5 percent of the total AUM respectively. While traditional vanilla products dominate in India, new Product categories viz. Exchange
Traded Funds (ETFs), Gold ETFs, Capital Protection and Overseas Funds have gradually been gaining popularity. As of March 2009, India had a total of 16 ETFs (0.3 percent of total AUM), while the US had a total of 728 ETFs as of December 2008.

**Markets**—While the mutual fund industry in India continues to be metro and urban centric, the mutual funds are beginning to tap Tier 2 and Tier 3 towns as a vital component of their growth strategy. The contribution of the Top 10 cities to total AUM has gradually declined from approximately 92 percent in 2005 to approximately 80 percent currently.

**Distribution Channels**—As of March 2009, the mutual fund industry had 92,499 registered distributors as compared to approximately 2.5 million insurance agents. The Independent Financial Advisors (IFAs) or Individual distributors, Corporate employees and corporates comprised 73, 21 percent and 6 percent respectively of the total distributor base. Banks in general, foreign banks and the leading new Private sector banks in particular, dominate the mutual Fund distribution with over 30 percent AUM share. National and Regional Distributors (including broker dealers) together with IFAs comprised 57 percent of the total AUM as of 2007. The public sector banks are gradually enhancing focus on mutual fund distribution to boost their fee income.

**Industry Structure**—The Indian mutual fund industry currently consists of 38 players that have been given regulatory approval by SEBI. The industry has witnessed a shift and has changed drastically in favour of private sector players, as the number of public sector players reduced from 11 in
2001 to 5 in 2009. The public sector has gradually ceded market share to the private sector. Public sector mutual funds comprised 21 percent of the AUM in 2009 as against 72 percent AUM share in 2001. The industry concentration has been stagnant in the four-year period from 2005 to 2008; the top 5 players comprising 50-52 percent of industry AUM. However, as of March 2009, the share of top 5 players increased to 58 percent, as against 38 percent in the US. The AUM share of the Top 10 players has consistently been In the vicinity of 75 percent. The mutual fund houses based on product portfolio and distribution strategy, the key elements of competitive strategy, can be segmented into three categories: The market leaders having presence across all product segments, players having dominant focus on a single product segment- debt or equity and players having niche focus on an emerging product.

**Category or distribution channels** - The market leaders have focused across product categories for a more diversified AUM base with an equitable product mix that helps maintain a consistent AUM size. Although the Indian market has relatively low entry barriers given the low minimum net worth required to venture into mutual fund business, existence of a strong local brand and a wide and deep distribution footprint are the key differentiators.

**Operations** - The Indian mutual fund industry while on a high growth path needs to address efficiency and customer centricity. AMCs have successfully been using outsourced service providers such as custodians, Registrar and Transfer Agents (R&T) and more recently, fund accountants, so that mutual funds can focus on core aspects of their business such as
product development and distribution. Functions that have been outsourced are custody services, fund services, registrar and transfer services aimed at investor servicing and cash management. Managing costs and ensuring investor satisfaction continue to be the key goals for all mutual funds today. However, there is likely to be scope for optimizing operations costs given the trend of rising administrative and associated costs as a percentage of AUM.

1.6.5 Present Status-Since the peak mutual fund industry saw in 2005-06 the mutual fund industry hasn’t been doing very well. The reasons are many. Firstly, because of the recent Global Financial meltdown, most of the Global Financial institutions are facing the problem of distress, the inability to manage funds, sustain liquidity, which ultimately leads to the position of insolvency of the financial institutions like banks, mutual fund organizations, and financial service providers (SatyaSekhar, 2012). However conditions have considerably improved in 2012. Large cap equity mutual funds returned 28 percent, small and madcap equity funds around 40 percent, Fixed Income and Bond funds returned over 10 percent (Business World, 2013). This recovery can mainly be attributed to revival of stock markets up by 26 percent in the year. Against this backdrop, the industry has seen the number of mutual funds grow from 32 to 44 over the last six years. The number of schemes has grown from 779 to 4,473 (counting various options of a single scheme as separate schemes) in the same period. Further, there have been 18 new entrants through the joint-venture (JV) or acquisition route, which include Nomura, Kbcbank, L&T finance, Goldmansachs, Natixix global amc, Trowe price, Pramerica.
1.6.6 Challenges and Issues - Investing through mutual funds is one of the most popular ways to take exposure to various asset classes like equities, government and corporate bonds, and gold, where investing is either risky or tedious for retail investors. Thus, mutual funds provide a cost effective and a convenient way to deploy surplus funds. Despite this, the Indian mutual fund Industry is facing many challenges and issues. The investors still shy away from mutual funds.

Low levels of Customer Awareness - Low customer awareness and financial literacy pose the biggest challenge to channelising household savings into mutual funds. IIMS Dataworks data released in 2007 establishes that low awareness levels among retail investors has a direct bearing on the low mutual fund off take in the retail segment. The general lack of understanding of mutual fund products amongst Indian investors is pervasive in metros and Tier 2 cities alike and majority of them draw little distinction in their approach to investing in mutual funds and direct stock market investments. A large majority of retail investors lack an understanding of risk-return, asset allocation and portfolio diversification concepts. Low awareness of SIPs in India has resulted in a majority of the customers investing in a lump sum manner. Low financial literacy has made it difficult to attract customers. A recent study - Visa's 2012 Financial Literacy Barometer, which assessed 28 markets - ranked India 23rd. Brazil fared the best, followed by Mexico, Australia, the US and Canada. The survey found that Indian families hold money management discussions infrequently, and that even educated people lack knowledge of investment products and investment plans.
**Limited Focus on Increasing Retail Penetration**-The Indian mutual fund industry had limited focus on building retail AUM and has only recently stepped up efforts to augment branch presence in Tier 2 and Tier 3 towns. Players have historically garnered AUM by targeting the institutional segment that comprises 63 percent AUM share. As of March 2008. Large ticket size, tax arbitrage available to corporates on investing in money market mutual funds, easy accessibility to institutional customers concentrated in Tier 1 cities are the factors instrumental in mutual fund houses focusing on the institutional segment. Building retail AUM requires significant distribution capability and a wide footprint to be able to penetrate into Tier 2 and Tier 3 towns, which AMCs have recently started focusing on. Institutional AUM, however, makes the industry vulnerable to the possibility of sudden redemption pressures that impact the fund performance.

**Limited Focus beyond the Top 20 Cities**-The mutual fund industry has continues to have limited penetration beyond the top 20 cities. Cities beyond Top 20 only comprise approximately 10 percent of the industry AUM as per industry practitioners. The retail population residing in Tier 2 and Tier 3 towns, even if aware and willing, are unable to invest in mutual funds owing to limited access to suitable distribution channels and investor servicing. The distribution network of most mutual fund houses is largely focused On the Top 20 cities given the high cost associated with deeper penetration into Tier 2 and Tier 3 towns. However, some of the mutual fund houses have begun focusing on cities beyond the Top 20 by building their branch presence and strengthening distribution reach through non-branch channels.
Limited Innovation in Product Offerings- The Indian mutual fund industry has largely been product-led and not sufficiently customer focused. The popularity of NFOs triggered a proliferation of schemes with a large number of non-differentiated products. The industry has had a limited focus on innovation and new product development, thereby, catering to the limited needs of the customer. Products that cater specifically to customer life stage needs such as education, marriage, and housing are yet to find their way in the Indian market. Despite the regulations for Real Estate Mutual Funds (REMF) being introduced in 2008, the market is still awaiting the first REMF launch. Further, relatively nascent product categories viz. multi-manager funds. That are among the most popular hybrid funds globally have not grown in India owing to the prevailing taxation structure. The Indian mutual fund industry offers limited investment options viz. capital guarantee products for the Indian investors, a large majority of whom are risk averse. The Indian market is still to witness the launch of Green funds, socially responsible investments, fund of hedge funds, enhanced money market funds, renewable and energy/ climate change funds. Despite tax benefits, equity-linked savings schemes have not generated sizable AUM. In March 2012, the AUM was approximately Rs 22,326 crore - about four per cent of total AUM. So product manufacturers focus on products for corporate investors rather than retail ones. There is a need to incentivise long-term savings in mutual funds. Liberalising third party investment management, particularly for insurance and pensions, could channel long-term funds to mutual funds. The insurance and pension industry would benefit from investment expertise, too. In the US, mutual funds account for 26 percent of the $17.9-trillion retirement market. Mutual
fund retirement assets represented nearly 40 percent of all mutual fund assets at the end of 2011.

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

**Limited Customer Engagement**-Mutual fund distributors have been facing questions on their competence, degree of engagement with customer and the value provided to the customer.

**Taxation Issues**-Tax rates do not encourage retail investors. For mutual funds, dividend distribution tax on equity schemes is zero. It is 12.5 percent on other schemes, and 25 percent on money market and liquid schemes. Long term capital gains tax is 10 percent with indexation and 20 percent without indexation for non-equity oriented schemes. Short term capital gains tax is 15 per cent for equity schemes and 30 percent for non-equity oriented ones. Taxation should be simplified to give retail investors incentive to put their money in mutual funds.