CHAPTER - IV

CAPITAL MARKET & MUTUAL FUNDS
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4.1 INTRODUCTION:

With deregulation of the financial services sector, there is a tremendous surge in the floating of mutual funds. No doubt, there are good prospects ahead for several such financial companies where the investor’s fancy for the units of these funds, has resulted in price earning ratios more than the period of capitalisation of such mutual funds.

In the vying race to achieve mutual fund supremacy, the financial companies have emerged as the harbinger of developing fund-management styles. In the last few years the number of choices facing investors in growth based mutual funds, has proliferated.

A sizeable part of the capital market in India is unorganized. Major part of private savings is invested in own business reflecting the predominance and the vitality of small sector. The substantial increase in private savings and the productivity of small farms and industry have manifested in the growth of nationalised banks despite government interference and decreasing productivity of human resources.
Dr. I.G. Patel, Ex-Governor of Reserve Bank of India rationalises the pace of growth of mutual funds in emerging capital market of India as follows:

"We should train and test our players much before we let them look to play with other people's money. In the ultimate analysis, the financial markets must not merely increase saving but must direct them to the most productive uses."

4.2 STOCKMARKET SERVICES AND MUTUAL FUNDS

Terminal year of eighth plan 1996-97 envisages mobilisation of Rs.25,000 crore annually by Indian capital market through stock market mechanism.

According to Neeraj Batra, Chief executive of Prime Securities Ltd:

"The Indian stock market has a considerable capacity to meet the coming challenges, but the concerned authorities will have to reduce the element of heavy speculation in the Indian bourses to bare minimum. The volumes and activities should be replaced with an actual delivery based system."

In the beginning of the 80s market capitalisation in India was 5 per cent of gross Domestic Product (GDP) Rs.5843 crores. At Present market capitalisation is placed around 40 percent of GDP Rs.2,50,000 crores. Though the growth is phenomenal, it is relatively low compared with the average ratio of round 60 percent in the developed western markets.
The annual average return on stocks in India, is in the region of 30-35 percent which is very high compared with annual average return of around 14 to 18 percent in the developed markets.

**TABLE - 4.1**

MARKET CAPITALIZATION AND P/E RATIOS IN SOME S.E ASIAN COUNTRIES.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>P/E RATIO (JUNE'92)</th>
<th>CAPITALIZATION MARCH'92 IN MILLION DOLARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>S.KOREA</td>
<td>14.8</td>
<td>95,000</td>
</tr>
<tr>
<td>TAIWAN</td>
<td>25.1</td>
<td>1,39,663</td>
</tr>
<tr>
<td>MALAYSIA</td>
<td>16.9</td>
<td>66,585</td>
</tr>
<tr>
<td>PHILIPPINES</td>
<td>15.2</td>
<td>11,780</td>
</tr>
<tr>
<td>THAILAND</td>
<td>14.4</td>
<td>46,726</td>
</tr>
<tr>
<td>INDONESIA</td>
<td>16.6</td>
<td>9,656</td>
</tr>
<tr>
<td>INDIA</td>
<td>39.1</td>
<td>77,740</td>
</tr>
</tbody>
</table>

SOURCE: Business standard, 10.11 92

The five principal areas of stock market are currently undergoing changes to meet the challenges posed by the international institutional investors.

* Stock exchanges
* Stock brokers
* SEBI
* Merchant Bankers
* Stock holding corporation of India
By the end of eighth plan, the pattern of investors will undergo metamorphosis. The brokers will be highly professional and considerably reduced in number. Scripless trading will finally be introduced. Much of Pherwani committee recommendations will have been implemented. Pherwani committee was appointed under the chairmanship of Ex-chairman N.H.B, Late M.J. Pherwani by Government of India to recommended stock market reforms. Pherwani recommended among other things for setting of a National Stock Exchange (NSE).

The stock holding corporation of India currently offers custodial services to state-owned financial institutions and mutual funds. This will soon turn into a central depository body.

Custodial services outside stock holding corporation of India is offered only by Citybank and Hongkong bank. There fore, there is large scope for setting of custodial banking services to bring about scripless trading. Mutual funds are to emerge as the new custodial bankers.

In the emerging scenario there will be three tiers of investors:

* Very large cash-rich individual investors with direct access to the stock market.

* The large institutional and fund-based investors operating through portfolio management services of brokers, finance companies and banks.

* The small investors will be forced to go to the mutual funds and pension funds for their investment needs.
SEDI has cleared the ways for the corporate bodies on the membership list of Indian stock exchanges. Mutual funds and broking corporate bodies will be ultimate security traders in the Indian capital market. The trend is discriminable in the form of Kotak Mahindra Finance, DSP Financial Consultants, Batliwala and Karani, Prime Securities, Enam Financial Services, JM Financial and Investment Services, Prabhudas Lilladhar (P) Ltd, Ind Bank Mutual Fund, SBI Capital, BOIFIN and CANFINA etc., whose prime activity in security trading centres on the stock markets.

Bombay Stock Exchanges and other Stock Exchanges are getting computerised to introduce screen-based trading by 1994. National Stock Exchange may emerge any time now. IDBI is working out the modalities to set up NSE.

According to Madhukar Morarka of Batliwala and Karani:

Soon there will be customised packages for investors to choose from, in the widely spread offices of the brokers.

Services advertised by Time Gurantee and DSJ Money Baggers are manifestation of such customised packages.

Mutual Funds find such customised package services and competitors unless they internalise such services into their schemes.
According to Sri C.V Ramakrisna ex-chairman of SEBI, the capital markets are indeed, engines of movement towards a market-oriented economy.

India is the largest among 35 emerging capital markets worldwide and is second to USA in having listed companies. Numerically there are about 7000 listed companies in India.

Despite this, out of 21% of national savings rate only 1% is harnessed under equity culture primarily due to market imperfections in the capital market. Inadequate investor and non-coordinated regulatory framework.

In India around 20% of the bourse trading result in delivery and 30% of the trading are speculative. Again there are 30% static outstanding equity and 20% are actually traded. Indian stock market index is built up on the premises of multiplying total outstanding equity including static outstanding equity with the high market multiplier of speculative market price. Market sentiment is created out of such index not reflecting the true trading phenomena. Without a real quantitative assistance the common investor in capital market relies heavily on references, rumours and imaginary trends. Though mutual funds can’t guarantee a minimum return their technical ability to study the market and of being prudent, efficient and smart investors in the market, the contributor to the collective saving scheme feel the perceptual security to invest in mutual funds not withstanding the market risk.
Under difficult stage of transitional Indian Capital Market, investor's interest is difficult to protect in all cases but at least in Mutual Funds fair play conditions and disclosure can be ensured. Mr G.V. Ramakrishna, Chairman, SEBI stated in his inaugural address at a National Seminar on 10th Jan '91 at New Delhi on 'Emerging trends in capital market' as follows:

"We have done this (Investor protection), as far as mutual funds are concerned. Already, the advertisements have stopped mentioning the maximum and minimum guarantee, some advertisements have started mentioning the risks, so that, there is a movement for a better code and better disclosures will come in next few months."

4.4 PUBLIC SECTOR ENTERPRISES AND MUTUAL FUNDS

Stock exchanges in India also serve the joint sector units and now public sector enterprises, Government companies such as Balmer Lawrie, Andrew Yule, Gujarat State Fertiliser Corp., Gujarat Narmada Fertiliser Corp., Hyderabad Allwyn, Polymer Corp. of Gujarat, were listed in stock exchanges. Then came the disinvestment of shares of central public sector companies through mutual fund route. With the floating of Public issues by Indian Petrochemical Limited (IPCL), a part of public limited companies share capital is open for public subscription.

Central Govt., State Govt., Municipalities, Improvement Trusts and other public corporations, issue automatically listed gilt-edged securities. Stock market trading in these securities are strength of RBI open market operation. Mutual funds are now the conduit for such open market operation by RBI.
4.5 MACRO-ECONOMIC PERSPECTIVE AND MUTUAL FUNDS

In Japan and South Korea the corporate sectors used to rely on bank credits to meet their short term funding requirements and operated with very high leverage. This was the historical path Indian business used to follow as well. Currently Japan and South Korea have reduced leverage through capital market funding by issuing Anglo-Saxon model securities.

From macro-economic perspective, the importance currently being given to development of the capital market in India stems out of this anglo-saxon experiment. This is manifested in promotion of mutual funds.

On adoption of the anglo-saxon model of financing in line with IMF and World Bank guidelines, there is much expectation on mutual fund based financial system. A resource scarce country like India can't afford a sophisticated Casino type stock market. Mutual funds are the buffers and stabilisers under such strategic model of financing.

4.6 INTERNATIONALISATION OF CAPITAL AND MUTUAL FUNDS

The need to stabilise and restructure the economy through reduction of budgetary deficit, control of monetary expansion, narrowing of balance of payment gap, raising resources for eighth plan and internationalising world wide change in policies favoured by IMF and World Bank are the compulsions of the Indian domestic economy.
External debt burden has to be reduced ultimately through increase in exports and saving surplus but simultaneously maintaining acceptable level of growth.

In the transitional period India is going to face a resources gap which only foreign inflow of funds can fill up.

The healthy and robust growth of mutual funds markets in India can attract funds from abroad. The current stock of equity holding of non-residents in emerging markets world over is estimated by the IFC at $17 Billion of which $11 billion is held through country funds.

The institutional investors in industrial countries, having huge investible funds; the USA public and private pension funds, control $2.7 trillion in assets; are increasingly looking for international diversification of their asset-portfolios to increase their returns and to spread risks.

The existing 9% level of international investment by pension funds is far below the level recommended by the experts such as Frank Russell, who advise 200 large sized pension funds, to have a portfolio mix of 70% domestic and 30% foreign equities to maximise annualised returns and to spread risks.

India can attract $2 billion of institutional investment provided Mutual funds innovate instruments tailored to suit foreign investors. The involvement of mutual funds will eliminate two major concerns in internationalisation of capital market directly viz,
1 - The possibility of take-overs of domestic firms by foreigners,

2 - The possibility of destabilising effects of large capital flows on the domestic capital markets, domestic money supply, exchange rate.

The south Korean strategy of internationalisation of capital markets passed through this Mutual Funds route as follows:

1. Immediately allowing foreign investors to invest indirectly in Korean Securities Companies and close-ended Mutual Funds managed by foreign securities companies.

2. By late 1980s, allowing direct portfolio investment in domestic securities and to permit Korean firms to raise equity funds with prior Government approval in external markets.


Indian economy has to follow the same course Via Mutual Fund route pending the health of the 'real sector' being perceived by foreign investors. Real sector consists of growing domestic markets, availability of natural resources and skilled manpower at reasonable rate, workable infrastructure and market-friendly regulatory environment.

The resources raised by India from International Capital Market through issue of international bonds i.e., foreign bonds and Eurobonds, is given below.
TABLE - 4.2
FOREIGN BOND RESOURCES RAISED BY INDIA

<table>
<thead>
<tr>
<th>Year</th>
<th>US $</th>
<th>Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>297.6</td>
<td>297.6</td>
</tr>
<tr>
<td>1985</td>
<td>417.8</td>
<td>417.8</td>
</tr>
<tr>
<td>1986</td>
<td>323.2</td>
<td>323.2</td>
</tr>
<tr>
<td>1987</td>
<td>377.0</td>
<td>377.0</td>
</tr>
<tr>
<td>1988</td>
<td>714.6</td>
<td>714.6</td>
</tr>
<tr>
<td>1989</td>
<td>668.3</td>
<td>668.3</td>
</tr>
<tr>
<td>1990</td>
<td>623.0</td>
<td>623.0</td>
</tr>
</tbody>
</table>


During 1989-90 IDBI raised resources from International Capital market through an issue for $ 100 million in Eurodollar bonds and 20 billion in Japanese capital market through a 'Samurai bond' issue.

But the opening up of the Indian capital market has come through the route of Mutual Funds' country Funds, which have provided an opportunity to international investors and non-resident Indians to test the growth potential of Indian Capital Market to pave way for successful bond issues.

The subscribers to these funds are pension funds, Life Assurance Scheme and institutional investors. 75 million pounds India fund, 86 in London and 60 million $ India Growth Fund, 1987 in USA were launched by UTI. Privately placed SBIMF India Magnum Fund received an overwhelming response of Us $ 157 million. Citi Bank and Can Bank Mutual Funds also launched successful country off-shore funds.
Capital market Magazine calculates Market Capitalization based on its pareto Analysis and selection of 1693 listed companies. Vol. VII/16 dt. 8.11.92 issue reveals following data:

- All Industry Composite Gross Profit Margin = 9.4
- All Industry composite P/E ratio = 26.5
- Total Market Capitalization (1693 Companies) = Rs. 199234.50

Shared Mistry surveying the situation of Indian stock market in Business Standard dt. 10.11.92 has accepted following statistics for the entire market of more than 6500 listed companies.

- Market Capitalization in US $ 77,740 Million
- Market Capitalization in Rs 2,50,000 Crores
- P/E ratio (June, 92) 39.1

The Economic Time dated 9.11.92 indicate following statistics for Mutual Funds.

- Market Capitalization Rs 42,630 Crores.

Investment pattern of Funds estimated total of all schemes as on 30.6.90 made by Business world, August 7-14, 1990 reveal that 60 percent of Mutual Funds' corpus have been invested in fixed income securities because of assured yield considerations and security of funds, 13 percent in investments of other nature and only 27 percent in speculative equity shares.
By extrapolation Rs 11510 crores of Mutual Funds Market capitalization is internalised in aggregate market capitalization.

Fig 4.1

<table>
<thead>
<tr>
<th>Capital Market</th>
<th>MF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rs. 238500 Crores.</td>
<td>Rs. 31000 Crores</td>
</tr>
</tbody>
</table>

Mutual Fund Market Capitalization.

Aggregate Market Capitalization of Capital Market.

Therefore Mutual Funds' contribution to aggregate market capitalization is 17 percent but can influence the stock market index to a much lower percentage i.e 4.6%.

But considering the magnitude of static equities at 80 percent and tradable equities at 20 percent as revealed by Sri G.V Ramakrishna, Chairman, SEBI, the Mutual Funds are capable of influencing stock market parameters to the extent of 23 percent at their present scale of operation.

The scenario will change if the imperfection of static equity is removed or the investment pattern of Mutual funds is changed.
The basic approach to Mutual Fund planning and policy making in India, is slowly emerging as a clearly discernible strategy. Though mutual fund is primarily an economic activity, both economic and noneconomic environment influence the organisation and policy of mutual funds. Among the critical elements of non-economic environment, the role of Government is very crucial. In this backdrop Mutual Funds have a ten-point emerging strategy for growth in India.

1) **Horizontalisation:** The investment base has to be horizontalised, schemes to be so well dispersed that there is constant inflow of new investors and diffused investors with wide income background to effect market integration.

2) **Structural Integration:** The time has come to attempt a structural integration of the small savings, deposits and capital unit cult, so that the economy is monetised, production increased and employment expanded. Mutual funds are most suited for such structural integration in the emerging scenario.

3) **Cost rationalisation:** Financial product managers work towards cost rationalisation to reduce inflation and to cope with low productivity. The capital market resource mobilisation is becoming increasingly costly. Cost rationalisation is achieved through efficient management of Mutual Funds in financial, marketing and investment areas.
4) **Corpus Optimisation:** The goal of higher productivity and lower cost is achieved in Mutual Funds through optimisation of resource mobilisation and utilisation as well as process optimisation.

5) **Conservation:** Conservation implies sustainability of a system so that the future generation is assured of integrational equity i.e. benefit to greater or, at least to same extent than the present generation. Exploitation of economy through Mutual Fund route for resource intensification is not to be at future cost i.e. loss of future credibility of the Mutual fund system. The regulatory mechanisms tend to ensure this.

6) **Capacity Utilisation:** It is an aspect of corpus build up, Planning and control. Capacity utilisation in Mutual Funds depends on better resource management, security management and opportunity management. It also depends on another crucial factor i.e., preventive vigilance rather than breakdown survey of the garnered resources.

7) **Technology Upgradation:** Modernisation in fund management techniques, investment in R and D and inducting on-line, real time transaction processing, custodial banking and security trading, are becoming increasingly critical for success of Mutual funds.

8) **Professionalisation of Management:** The growing competition in the market needs to be matched by a total change in management system. Mutual Funds need sensitive professional managers for its nodal activities like corpus planning,
marketing, security trading, custodial banking, portfolio management and technological upgradation.

9) **Internationalisation**: Indian resource market is under pressure from competing forces of opportunities arising out of constantly increasing demands. The global resource market is both huge and open. Some unique selling propositions backed by policy of liberalisation and diversification will enable Indian Mutual Funds to be internationalised beyond present activities.

10) **Quality Orientation**: As mutual Funds must stay on a continuing basis to become market leaders in financial management, they need quality orientation to meet both domestic and international standards. This needs continuous R & D supervision backed by well laid down programmes, policies and procedures.

### 4.9 RECENT DEVELOPMENT IN MUTUAL FUNDS:

Within a short span of five to six years mutual fund operation has become an integral part of the Indian financial scene and is poised for rapid growth in the near future. More than 35 million investors in India have their savings tucked away in mutual funds. And the total amount is around Rs. 40,000 crores in 1993. This total amount of mutual funds was Rs. 30,000 crores in 1992 as compared with a mere Rs. 4,000 crores in 1987. This shows a ten time increase in the amount of mutual funds in the year 1993 as compared to 1987.
With emphasis on increase in domestic savings and improvement in deployment of investment through markets, the need and scope for mutual fund operation has increased tremendously. The basic purpose of reforms in the financial sector was to enhance the generation of domestic resources thereby reducing the dependence (in the long run) on outside funds. This calls for a market-based institution which can tap the vast potential of domestic savings and channelise them for profitable investments. Mutual funds are not only best suited for the purpose but also capable of meeting this challenge.

It is the intense marketing campaign of bank funds and their wide network of collection centres in the form of branches that have helped in the phenomenal growth of mutual funds. Thus, bank-sponsored mutual funds have become popular on account of "guaranteed return", "trust" in banks and their "accessibility and familiarity".

Private mutual funds and foreign mutual funds have become very popular in India because of their goodwill and fixed deposits of companies and also debentures with respect to all attributes; that is, safety, liquidity and return.

From the surveys conducted for this research throw up some interesting pointers on what investors know and feel about mutual funds. For starters, the level of awareness about these funds is rather low. Apart from UTI, the mutual funds of banks and insurance institutions too are not considered such. SBI Mutual
Fund, it appears, has been able to mop up funds more because of the goodwill that the bank enjoys.

At present the investor in India looks at mutual funds as a substitute for fixed deposits in banks rather than as a substitute for investment in stocks. Most of the Indian investors are not willing to invest in mutual funds unless there is a promise of minimum return. They consider the schemes without such promise as not very safe.

The significant feature of mutual fund in India is the guaranteed returns offered by a majority of them. This is responsible for gaining popularity among investors. One of the issues concerns whether the mutual funds should offer and advertise guaranteed returns. Strictly speaking, mutual funds are market instruments and are subject to market risks. No mutual funds abroad offers guaranteed income. The securities and Exchange Board of India prohibited the mutual funds from offering products with guaranteed returns. The SEBI's directive on code of advertisements is in keeping with the international practice.

Direct participation in stockmarkets by small investors is a feature peculiar to the Indian capital market. The world over, the reverse is true. In Britain, more than 70 percent of the stocks are traded through the mutual funds.

In September, 1993 an executive of a mutual fund found it difficult to give a convincing answer to an investor who wanted the fund to buy back its own schemes from the market. The fund manager was at a loss because the investor reposed greater faith in
the market than the fund's claim about the intrinsic value of the share. The unit was quoted on the bourses at Rs.8.50 while its net asset value (NAV) was much higher at Rs.14/-.

The investor was one of those fence-sitters who could not decide whether he should stay with the fund or sell his units. The NAV of the unit suggested that he should continue with the scheme, but the market price indicated that he should quit.

The decision to sell would mean loss because the script was not only quoting much below the NAV, but it was also lower than its face value. If the dilemma before the investor was to decide either way, the fund manager was worried about the damage the market trends would do to his mutual fund. His concern was that the market would drive investors away from his funds.

But in October, 1993 mutual fund managers heaved a sigh of relief when the SEBI permitted them to conduct one-way operations in the market to bring the prices close to the NAVs. Even before all the funds could place buy-orders of their own schemes, the prices started moving up gradually.

Mutual funds expectation that the turnaround in market sentiment would come to the rescue of some of their schemes were belied. Some of them felt that the only way out was to enter the market and give these scripts a push so that they move up the ladder.

The timing of SEBI's decision to allow "buy-back" facility suits the existing mutual funds who are facing stiff
competition from new entrants like ICICI MF, Morgan Stanley Asset Management Company and Kothari Pioneer Fund among others.

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