Chapter 2
Mutual Funds: A Conceptual Review

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2.1 Mutual Funds: A Conceptual Review

The previous chapter was devoted to the introduction of the study that includes the review of the available literature, objective of the study, hypothesis, research methodology used and the framework of the study. The present chapter is related to genesis of mutual funds, its concepts and working. It also deals with the various entities of mutual funds, classification of mutual funds, advantages and disadvantages of investing in mutual funds.

2.2 A Brief History of Mutual Funds

The concept of mutual funds is very old. At the very early stage, Egyptians and other were selling shares in vessels and caravans to trade off risk of these perilous ventures. It was in 1822 that an investment thrust called ‘Societe General de Belgique’ was formed in Belgium. This institution was formed by the Royal Family of Holland and acquired securities of wide range of companies, thus adopting diversification as a means to minimize risk. In fact, the investment diversification is the main attractions of mutual funds as the small investor are also able to allocate their little funds in diversified way and minimize risks. However, ‘The Foreign and Colonial Government Trust’ founded in 1868 in London is recognized as pioneer of modern concept of mutual funds. Later in 1873, Robert Fleming at Dundee established the Scottish American Trust. In England, the early institutions were created under legal form known as the old English Trust.

Most of the investment companies established during 1860’s were of close end type and invested primarily in stock market. Due to this very
nature, the performances of these companies were closely related to stock market booms and crashes. It was for this reason that in a very short span of time their number increased to over 50, but in the 1890 because of stock market crisis very few were left 4.

During this period a few investment companies came up in the US, however their growth was in nowhere similar to that achieved in UK. The reason for this was lack of investor interest in stock market. But the booming stock market in 1920’s led to the arrival of investment companies in the US. During this phase, open - end investment companies were popular as they allowed borrowing money for investing in securities. This enabled them to increase their shareholders return in a booming market. It was during this period the Massachusetts Investment Trust, was launched in Boston in 1924. This heralded the arrival of modern mutual funds. Also during this period other mutual funds were launched in the US. The period 1925-29, witnessed a substantial expansion of investment trust movement in the US 5.

The third phase of evolution of investment companies started with the creation of the Securities and Exchange Commission (SEC) in USA. The enactment of the securities Exchange act of 1934 which put in place safeguard to protect investor; mutual funds were required to register with the SEC and to provide disclosure in the form of a prospectus. The investment companies Act of 1940 put in place additional regulations that required more disclosures and sought to minimize grievances of investors of different categories. It also provided rules and regulations for the establishment and management of mutual funds 6.
However during the Second World War period mutual funds lost its popularity, as security market was worst affected. People shied away from investing in mutual funds as it no longer offered better returns. This condition was altered after world was II, renewed interest in mutual funds developed as, stock market rose. By offering professional management to small and medium-size investors, mutual funds were able to attract more funds and acquire more assets for investment in rising stock markets. As a result they increased their assets at a compound annual rate of nearly 18 percent from 1945 to 1965 in the USA\textsuperscript{7}. As these funds invested predominantly in the equities market, the decline of the stock market in 1970s again resulted in poor returns on mutual funds thus becoming unattractive for the investors. This made investors to look for other attractive avenues for investment. In the absence of any such attractive avenues, investors were inclined towards to invest in money market which was at that time offering higher returns. With the growing interests of investors in the money market, mutual funds came up with money market funds, funds that invested exclusively in the money market. The success of money market funds accelerated the evolution of other kinds of innovative mutual funds like fixed income funds, tax exempt mutual funds, emerging market mutual funds etc. It became the starting point for the development of present day mutual funds industry. Today mutual funds offer various kinds of scheme for different categories of investors. This has become the prime factor for the growth and development of mutual funds industry all over the world\textsuperscript{8}. The number of mutual fund grew from 68 funds in 1940 to more than 3000 funds all over the world as shown in table 2.1 below:
Table 2.1
Number of Mutual Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
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<tbody>
<tr>
<td>1940</td>
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</tr>
<tr>
<td>1945</td>
<td>73</td>
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<td>1988</td>
<td>2718</td>
</tr>
<tr>
<td>1989</td>
<td>2918</td>
</tr>
<tr>
<td>1990</td>
<td>&gt; 3000</td>
</tr>
</tbody>
</table>

Source: Mutual fund fact Book, 1990, p. 2

2.3 Concept of Mutual Fund

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 then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to
the number of units owned by them. Thus, a mutual fund is the most suitable investment for the common person as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.\(^9\)

The primary objective of all mutual funds is to provide better returns to investor by minimizing the risk associated with capital market investment\(^{10}\). Hence mutual funds investment are made in a manner as to ensure its investors a triple benefit of steady return and capital appreciation along with low risk.\(^{11}\) By pooling their assets through mutual funds investors achieve economies of scale.

Mutual funds have been defined in different ways by different authors, meaning one and the same thing, “it is a non depository or non-banking financial intermediary which act as an important vehicle for bringing wealth holders and deficit units together indirectly”.\(^{12}\)

Mutual funds are corporations which accepts dollars, to buy stocks, long-term bonds, short-term debt instruments issued by business or government units, these corporation pools funds and thus reduce risk by diversification.\(^{13}\)

SEBI (Mutual Funds) regulation 1993, defines mutual funds as follows: “Mutual Funds means a funds established in the form of a trust by sponsor to raise money by the trustees through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations\(^{14}\)”

However the above definition was revised by the SEBI (Mutual Funds) Regulations 1996 which defines a mutual fund established in the form
of a trust to raise money through the sale of units to the public, or a section of the public, under one or more schemes for investment in securities including money market instruments.

Since the above definition is limited in nature and restricts the scope of operations of mutual funds. Mutual funds were subsequently allowed to diversify their activities in following areas:

- Management of offshore funds
- Providing advice to offshore funds
- Management of pension or provident funds
- Management of venture capital funds
- Management of money market funds
- Management of real estate funds

The regulation deals with various issues relating to the launching, advertising and listing of mutual funds schemes. All the schemes launched by the AMC required to be approved by the trustee.

In a sense, MF is the purest form of intermediary because there is almost a movement of money between unit holders (savers) and the securities in which the fund invests. Unit holders are indicated in what type of securities their funds will be invested. Values of the securities held in the fund portfolio is translated on the daily basis directly to the value of the fund units held by the unit holder. Thus by making investment in mutual funds, one can avail services of professional at a very low cost and receive adequate endorsement of safety and liquidity of one’s investment.
A mutual funds investment is, thus prone only to market risk. The flow-chart below describes the working of mutual funds.

**Figure 2.1**

**Mutual Fund Operation Flow Chart**

- Pool their money with
- Passed back to
- Generates
- Invest in
- Returns
- Fund Manager
- Securities
- Investor

Source: AMFI Investor’s Concise Guide

### 2.4 Entities in Mutual Fund Operations

Mutual funds operations in India involve the following entities: the sponsor, the trustees, the asset management companies, the custodian and the registrars and transfer agent.

#### 2.4.1 Sponsor

The sponsor of mutual funds is like promoter of a company. The sponsor may be bank, a financial institution, or financial service company. It may be Indian or foreign. SEBI Regulation, 1996 contains certain provision regarding the sponsor of the mutual funds. As per the definitions of SEBI Regulation Act 1996, “A sponsor is any person while acting alone or combination with another body corporate who establishes
a mutual fund”. The sponsor should have a sound track record and general reputation of fairness and integrity in all his business and transaction. The regulations specify that the sponsor should contribute at least 40% to the net worth of the AMC.

2.4.2 Trustees

A trust is a national entity that can not contract in its own name, so the trust enters into contracts in the name of trustees. Appointed by the sponsor, the trustee can be either individuals or a corporate body. As per 1996 regulations, a mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian registration Act, 1908 (16 of 1908), executed by the sponsor in favour of trustees named in such instruments. The mutual fund is managed by the board of trustees, or Trustee Company, and the sponsor executes the trust deeds in favour of the trustee. Money is raised by the mutual fund by the sale of units under various schemes as per SEBI guidelines.

2.4.3 Assets Management Company

It is also referred to as investment manager, is a separate company appointed by the trustees to run the mutual funds. According to Regulation 20(d) of SEBI (mutual funds) Regulations, 1993, an “Asset Management Company” means a company formed and registered under Company Act, 1956 and approved by the board under Regulation 20 of the Company Act. The asset management company shall be authorized for business by SEBI on the basis of following criteria:
- AMCs, which already exist, should have sound track record, fairness in dealing coupled with good reputation.

- The Director of AMCs should have ten years of professional experience in relevant field and a man of high integrity.

- The board of the asset management company should have at least 50 percent independent director.

- The AMC should have minimum net worth of Rs. 5 crores.

2.4.4 Custodian

The custodian handles the investment back office operations of a mutual fund. As per SEBI Regulation 1996, mutual fund shall appoint custodian for carrying out custodial services for schemes of the fund and intimate the same to SEBI within fifteen days of appointment. The responsibility of custodians are as follows:

- Receipt and delivery of securities
- Holding of securities
- Collecting income
- Holding and processing cost

2.4.5 Registrar and transfer agent

The registrars and transfer agents handle investor’s related services such as issuing units, sending fact sheet and annual reports and so on. Some funds handle such function in house, while other outsource it to SEBI registrars and transfer agents. The legal structure of Indian Mutual Funds as laid down by SEBI is shown in figure 2.2.
Figure 2.2
Structure of Indian Mutual Funds

Source: Sadhak, H., Mutual funds in India Marketing strategies and investment practices, p.164
2.5 Classification of Mutual Funds

In India, various mutual funds are offering variety of schemes to investors. These schemes can be broadly classified into four categories. These four categories are:

1. Operational classification
2. Portfolio classification
3. Geographical classification
4. Structural classification

2.5.1 Operational Classifications

On the basis of execution and operation mutual fund schemes can be classified as open – ended. Close- ended and interval schemes.

2.5.2 Open- Ended Schemes

SEBI regulations defines open- ended schemes as “a scheme of mutual fund which is offering unit for sale or has outstanding any redeemable units and which does not specify any duration for redemption or repurchase of units” 21. Open- ended mutual funds are open throughout the year for investment and redemptions. Open- ended schemes are more transparent as the units are directly bought and sold by the fund 22. This also provides instantaneous liquidity23. Initially units are offered through public issue opened for a maximum period of 45 days and after the date of closure, entry to investors shall be closed for few weeks. The minimum corpus of open- ended scheme is Rs. 50 crore or 60 percent of the targeted amount, in any case the higher of the two is considered. To overcome speculation, open-end mutual funds offers fair price related to the funds.
net asset value or true worth of the fund. Open-ended funds charge processing fees whenever an individual investor either sale or purchase the units. This is known as load. By offering tailored made products for the various categories of investors, open-ended mutual funds scheme has become a big boon in India. This is evident from the fact that 592 open-ended schemes were in operation as on March 2008. The net asset under these schemes was Rs 369239 crore.

2.5.3 Close-Ended Scheme

A close-ended fund or scheme has a stipulated maturity period e.g. 5-7 years. The units are offered to the investors through public issue and after the date of closure, the entry to the investors is closed. Investors can thereafter buy or sell the units of the schemes on the stock exchange where the units are listed. They may be sold at premium or discount (normally at discount), and the investor may not get NAV-related value. In spite of this a close-ended scheme is considered more stable because of the fixed capitalization. However the popularity of close-ended scheme has decreased in India since 1991. As during 1990-91, 18 scheme were launched out of which 15(83%) were close-ended and 3 (17%) were open-ended. But in 2008 of out of 956 schemes, 364(38%) were close-ended and 592(62%) were open-ended.

2.6 Portfolio Classification

Classification of funds on the basis of portfolio is important from the point of view of investors as it indicate pattern of asset allocation and degree of implicit risk. It enables investor to judge the risk-return relationship and to take informed decision on investment. The following are important categories of funds according to this classification.
2.6.1 Growth/Equity Oriented Schemes

The aim of growth funds is to provide capital appreciation over the medium to long-term. Such schemes normally invest a major part of their corpus in equities. The schemes may or may not declare dividends. This has high risk with high gain potential and low current income assurance. It is ideal for investors seeking growth over a period of time in other words investor is ready to make investment for longer period. The number of growth/equity oriented schemes at the end March, 2008 was 313 while average net asset under management was 177684.07 crore\(^{28}\).

2.6.2 Income/Debt Oriented Scheme

The aim of income fund is to provide regular and steady income to investors. Such scheme generally invests in fixed income securities such as bonds, corporate debentures, government securities and money market instruments. Such funds are less risky compared to equity schemes. These funds are not affected because of fluctuations in equity market. Other variant of income funds are dedicated bond funds and gilt funds, while the former invest in government and corporate bonds, the latter invest primarily in government securities. By the end of March, 2008 there were 593 incomes or debt oriented schemes and the average net asset under management was Rs. 340641.20 crore.\(^{29}\)

2.6.3 Balanced Scheme

The aim of balanced funds is to provide both growth and regular income as such scheme invest both in equities and fixed income securities in the proportion indicated in their offer document. There are appropriate for investors looking for moderate growth. They generally invest 40-60% in
equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds. There were 37 balanced schemes with average net asset under management of Rs. 16655.05 crore at the end of March, 2008. 30

2.6.4 Bond Funds

Bond fund are by nature like debt funds and serve the purpose of those investors who have the capacity to bear risk and want to earn a little higher than other safe avenues of investments like post office and bank fixed deposits. Bond funds invest in debt instruments such as corporate papers, papers issued by government of India etc. with different maturity and quality. To meet the liquidity needs investments is also made in money market instruments and call papers. Investment made in bond funds is secure and give steady income and it is more liquid, diversified and conservative investments with modest capital gains31. Investments made in this are less risky and provide fixed return.

2.6.5 Money Market Mutual Funds (MMMF)

Money Market Mutual Funds aims to provide the maximum current income together with safety and liquidity. These funds are generally invested in money market instruments such as Treasury bills, certificate of deposits, commercial papers, bill discounting etc. MMMFs enable retail investors to earn return, otherwise available only to large and institutional investors.32 MMMFs also offer the advantage of bulk purchases, access to short term markets, expertise of a professional fund manager, lower transaction cost, liquidity and flexibility.33
The term liquid funds and money market funds are often used interchangeably as they invest eighty percent of their corpus in money market instruments. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short period exposed to specific sector. The net asset under management under this category was Rs.102594.16crore in March 2008.34

2.6.6 Index Funds

These funds invest only in those shares, which are included in the market indices and in exactly the same proportion. NAVs of such scheme would rise or fall in accordance with the rise or fall in the index, though not exactly by the same percentage due to some factor known as “tracking error” in technical term. Tracking error measures the standard deviation of the differences between the portfolio and index return. Necessary disclosures in this regard are made in the offer document of the mutual fund scheme.

2.6.7 Tax Saving Schemes

These are equity linked saving schemes (ELSS) offering tax rebates to the investors under section 80 C of the income tax act 1961. The scheme is subject to securities and exchange board of India (Mutual Funds) regulations 1996 and the notifications issued by the Ministry of Finance (Department of economic Affairs), government of India regarding ELSS. The minimum lock-in-period is three years and the scheme shall not provide any type of liquidity during this period. The investment in ELSS is better than other avenues of investment as it has return potential and the lock in period is minimum compared to National Savings Certificates (NSC)and Public Provident Funds (PPF)having lock in period of six and
fifteen years respectively. The dividend earned in an ELSS is tax free. The returns at maturity are also tax-free. It has because of these reasons become popular mode of investments as at the end of March, 2008 there were 43 ELSS schemes and the average net asset under management was Rs. 15780.08 crore.\(^{35}\)

2.6.8 Real Estate Funds

SEBI defines Real Estate Mutual Funds (REMF) as schemes of a mutual fund established in the form of trust, which directly or indirectly invest in real estate assets or other permissible assets. As per the definition of the regulations real estate include immovable property in India located in certain specified cities or SEZs which is fully constructed and useable and free from any litigation having clear title documents. The objectives behind the setting up of Real Estate Mutual Funds are to provide the property market with an investor. It is newer and attractive avenues for investments.\(^{36}\) REMF are required to invest thirty five percent of the net assets of the schemes directly in real estate and there is no limit to the maximum investments.\(^{37}\)

2.6.9 Gilt Funds

Gilt funds are mutual funds schemes launched by various asset management companies with the sole objectives of investment in government securities. Government securities include government dated securities, state government securities and Treasury bill.\(^{38}\) It is because of this reason gilt funds have no default risk. However NAVs of gilt schemes may fluctuate due to change in interest rate and other economic factors. During the end of the period March, 2008 there were 30 gilt schemes with average net asset under management was Rs. 2566.33 crore.\(^{39}\)
2.6.10 Systematic Investment Plan (SIP)

It is a method of investing a fixed sum, on a regular basis, in a mutual fund scheme. It is similar to regular saving schemes like a recurring deposit. An SIP allows one to buy units on a given date each month, so that one can implement a saving plan for themselves. A SIP can be started with as small as Rs 500 per month in ELSS schemes to Rs 1,000 per month in diversified equity schemes. Under this an investor is given the option of preparing a predetermined number of post dated cheque in favour of the fund. The SIP almost seems to be boon for the investors. It makes investment affordable, it channelizes regular savings into the stock market, hence smoothening volatility. SIP is an approach to investment, wherein fixed amount is invested at regular period in the same scheme.

2.6.11 Load funds

A load fund is one that charges a commission for entry or exit. That is each time one buys or sells units in the funds, a charge will be payable. This charge is used by the mutual funds for marketing and distribution expenses.

2.6.12 No-Load Funds

A no-load fund is that does not charge a commission for entry or exit. It means that investors can enter the fund/ scheme at NAV purchase or sale of units.

2.6.13 Short Term Plans (STPs)

It is 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.
2.6.14 Fixed Maturity Plans

Fixed Maturity Plans (FMPs) are investment schemes floated by mutual funds and are close ended with a fixed tenure, the maturity period ranging from one month to three/five years. These plans are predominantly debt-oriented, while some of them may have a small equity component. The objective of such a scheme is to generate steady returns over a fixed-maturity period and protect the investor against market fluctuations. FMPs are typically passively managed fixed income schemes with the fund manager locking in to investments with maturities corresponding with the maturity of the plan. FMPs are not guaranteed products.

2.6.15 Capital Protection Oriented Schemes

Capital Protection Oriented Schemes are schemes that endeavor to protect the capital as the primary objective by investing in high quality fixed income securities and generate capital appreciation by investing in equity/equity related instruments as a secondary objective. The first Capital Protection Oriented Fund in India, Franklin Templeton Capital Protection Oriented Fund opened for subscription on October 31, 2006.

2.6.16 Gold Exchange Traded Funds (GETFs)

Gold Exchange Traded Funds offer investors an innovative, cost-efficient and secure way to access the gold market. Gold ETFs are intended to offer investors a means of participating in the gold bullion market by buying and selling units on the Stock Exchanges, without taking physical delivery of gold. The first Gold ETF in India, Benchmark GETF, opened for
subscription on February 15, 2007 and listed on the NSE on April 17, 2007.

2.6.17 Quantitative Funds

A quantitative fund is an investment fund that selects securities based on quantitative analysis. The managers of such funds build computer-based models to determine whether or not an investment is attractive. In a pure "quant shop" the final decision to buy or sell is made by the model. However, there is a middle ground where the fund manager will use human judgment in addition to a quantitative model. The first Quant based Mutual Fund Scheme in India, Lotus Agile Fund opened for subscription on October 25, 2007.

2.6.18 Funds Investing Abroad

With the opening up of the Indian economy, Mutual Funds have been permitted to invest in foreign securities/ American Depository Receipts (ADRs) / Global Depository Receipts (GDRs). Some of such schemes are dedicated funds for investment abroad while others invest partly in foreign securities and partly in domestic securities. While most such schemes invest in securities across the world there are also schemes which are country specific in their investment approach. Realizing the importance of investment in abroad, RBI has increased the aggregate mutual fund investment limit overseas from $4 billion to $5 billion.

2.6.19 Fund of Funds (FOFs)

Fund of Funds are schemes that invest in other mutual fund schemes. The portfolio of these schemes comprise only of units of other mutual fund schemes and cash / money market securities/ short term
deposits pending deployment. The first FOF in India was launched by Franklin Templeton Mutual Fund on October 17, 2003. Fund of Funds can be Sector specific e.g. Real Estate FOFs, Theme specific e.g. Equity FOFs, Objective specific e.g. Life Stages FOFs or Style specific e.g. Aggressive/ Cautious FOFs etc. It is for this reason investment in FOF is advantageous compared to others as it enables to construct a compact portfolio by reducing the number of funds and at the same time not compromising on diversification 45. It also ensures that assets allocation between equity and debt are at desirable level meeting the investment objectives. It also offers the advantage of saving costs like entry or exit cost as no such cost is charged when there is portfolio rebalancing.

2.7 Geographical Classification

On the basis of geographical limits, mutual funds schemes can be classified into domestic and off shore mutual funds.

2.7.1 Domestic Mutual Funds

Domestic mutual fund schemes mobilize the savings of the country’s citizens. However, NRIs and foreign investors can invest in these schemes. This means that all marketing activity related to domestic mutual funds schemes will be limited to India or the country in operation only. Almost all the schemes available in India are of domestic mutual funds schemes by nature.

2.7.2 Off-Shore Mutual Funds

These funds enable NRIs and international investors to participate in the Indian capital market. These funds are governed by the rules and procedure of Department of Economic Affairs, Ministry of Finance and the
directors of RBI. The UTI was the first institution to launch off shore mutual funds. India fund in London, 1986 and mobilize 7.5 Cr. pounds. 

2.8 **Structural Classification of Mutual Funds**

From the point of view of financial market structure, mutual funds can be divided into two categories namely:

a) Capital market mutual funds

b) Money market mutual funds.

Mutual funds generally invest the pooled resources in the capital market instruments whereas money market mutual funds invest in money market instruments.

2.9 **Categories of investors eligible to Invest in Indian Mutual Funds Industry**

- Resident Individuals
- Indian Companies
- Indian trusts and charitable institutions
- Banks
- Non Banking Financial Companies (NBFC’s)
- Insurance companies
- Provident funds
- Non-resident Indians
- Overseas Corporate Bodies (OCB’s)
- SEBI registered Foreign Institutional Investor (FII’s)
2.10 Distribution channels in the Mutual Fund Industry

The role of the distribution channels remains critical as it helps stave off competition by maintaining relationship, providing advisory services and customizing need based solution. The success of any mutual funds depends upon appropriate distribution channels. In India, AMCs work with five distinct distribution channels those are direct, banking, retail, corporate and individual financial adviser etc. This is depicted in the figure 2.3.

Figure 2.3
Multi Channel Distribution

Source: ICI Investment Company Institute
2.10.1 The Direct Channels

In the direct channel, customers invest in the schemes directly through AMC. In most cases, the company does not provide any investment advice, so these investors have to carry out their own research and select schemes themselves. The fund companies provide several tools to investors who invest through this channel. This includes monthly account statement, processing of transaction, and maintenance of records. In this channel most investors can invest through websites, or receive information through telephonic services provided by the company. About 10-20% of the total sales of an AMC come through this direct channel.\(^{48}\)

2.10.2 The Banking Channel

The large customer bases of banks, in developed countries, have played an important role in the selling MFs. In the recent years, this channel has also opened up in India. Banks operating in India, including public sector, private and foreign banks have established tie-up with various fund companies for providing distribution of various mutual funds schemes.

The banking channel is likely to develop as the most vital distribution channel for fund companies as there are several reasons for the same. Customers remain invested in banks for long periods of time and therefore banks maintain a relationship of trust with their customers. Customers rely on advice provided to them by bankers as they are always on the look out for better investment avenues. Bankers are guiding customers about various funds. An additional advantage that banks provide is that the concerned customer becomes a permanent contact of the banks and therefore can be reached during launch of (new fund offer)
NFO or new schemes any time in the future. As per the survey conducted by Halder (2008), 14.7% percent of the people were informed about various funds through their banks.

### 2.10.3 The Retail Channel

A customer can deal directly with a sub broker belonging to a distribution company, instead of taking trouble of dealing with several agents. Distribution companies sell the schemes of several fund houses simultaneously and brokerage is paid by the AMC whose funds they sell. The retail channel offers the benefits of specialist knowledge and established client contact and therefore private fund houses generally prefer this channel. Some of the major players in India in this channel are Karvey, Bajaj Capital, and integrated enterprise. The key factor for this channel to sell a company’s fund is the brokerage earned through selling mutual fund products. The banking and retail channel generally contribute to about 50-70% of the total Asset Under Management (AUM).

### 2.10.4 The Corporate Channel

The corporate channel includes a variety of institutions that invest in shares on the company’s name. These are businesses, trust, and even state and local governments. For institutional investors, fund managers prefer to create special funds and share classes. Corporate can either invest directly in mutual funds, or through an intermediary such as a distribution house or a bank. Corporate have varying degree of awareness about mutual fund products and are well versed with the performance and composition of various funds. In order to provide information to such clients, fund companies usually organize presentation for these companies or set-up meetings with the finance managers.
2.10.5 Individual Financial Advisors (IFA) or Agents

Relationship plays an important role while selling mutual fund products. An agent is an essential channel between investors and the mutual fund products. The IFA channel is the oldest channel for distribution and was widely employed at the time when UTI monopoly was in the market. An agent is who basically acts as an interface between the customer and the fund house. There is a unique system in place in India, wherein several sub-brokers are working under one main broker. The huge network of sub-brokers, thus ensure larger market penetration and geographic coverage. As per AMFI, over one-lakh agents are registered to sell mutual funds products to various categories of investors. These agents advise the customers on the kind of product that caters to the need of the client.\(^{51}\)

2.11 Rights of investors in respect of service standard

Investor is entitled to following rights as per regulation of SEBI:

- Investors are entitled to receive dividends declared in a scheme within 30 days
- Redemption proceeds have to be sent to investors within 10 days
- If an investor fails to claim the dividend or redemption proceeds he has the rights to claim it up to a period of 3 years from the due date at the then prevailing NAV.
- Mutual funds have to allot units within 30 days of the IPO and also open the scheme for redemption, if it is an open-ended scheme
• Mutual funds have to publish their half yearly results in at least one national daily and publish their entire portfolios, at least once in 6 months. Such disclosure should be done within 30 days from 6 monthly account closing dates of the fund.

• Trustees will have to ensure that any information having a material impact on the unit holders investments should be made public by the mutual fund.

• If 75% of the unit holders so decide, that the scheme can be wound up then the meeting of unit holders can be called and appointment of the AMC of the mutual fund can be terminated.

• If there is any change in the fundamental attributes of the scheme, the unit holders have to be notified through a letter. They also have a right to repurchase at NAV without any load, before such change is effected.

• Unit holders have the right to inspect certain documents

2.11.1 Limitations of Investor Rights

• Investors cannot lodge complaints against the Trustees (with the Registrar of Public Trusts) or the AMC with the Company Law Board (CLB).

• Investors cannot lodge complaints with SEBI for noncompliance.

• Investors cannot be compensated if the performance of the fund is below expectations.
2.12 Importance or Benefits of Mutual Fund

The mutual fund industry has grown at a phenomenal rate in the recent past. Mutual funds investment is considered as a boon to Indian individual investors as there is a huge growth potential which will ultimately benefit them. The following are some of the important advantages of mutual funds investment.

2.12.1 Mobilizing savings for investment

A number of schemes are being offered by mutual funds (MFs) so as to meet the varied requirements of the peoples. The mobilized savings are directed towards capital investments directly. In the absence of MFs these savings would have remained idle. Thus the resources mobilized by the mutual funds are invested in the capital market which helps to reduce the gap between savings and investment.

2.12.2 Wide portfolio investment

Now the investors can enjoy the wide portfolio investment held by the mutual fund. The fund diversifies its risks by investing in large varieties of shares and bonds which cannot be done by small and medium investor. This is in accordance with the maxim not to lay all eggs in one basket.

2.12.3 Better yields

Due to the large funds mutual funds are able buy cheaper and sell dearer than the small and medium investors. Thus they are able to get better market rates and lower rates of brokerage. So they provide better yield to their customers. They also enjoy the economies of scale and can
reduce the cost of capital market participation. This enables even the small investor to gain benefits out of their investment.

2.12.4 Expertise investment service at low cost

The management of the fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. Thus, investors are assured of quality services in their best interest. The intermediation fee is the lowest being 1% in the case of a mutual fund.

2.12.5 Research services

Mutual funds investment are subject to market risks, therefore it is essential that investment are made only after having through knowledge about the market. To meet this requirement each fund maintains large research team, which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share. Thus investments are made purely on the basis of a thorough research.

2.12.6 Tax benefits

Certain funds offer tax benefits to its customers. Thus, apart from dividend, interest and capital appreciation, investors also stand to get the benefit of tax concession. Under the wealth tax act, investments in MFs are exempted up to Rs. 5 lakhs. Thus investment in mutual funds gives double benefit of tax concession and capital gains.

2.12.7 Flexible investment schedule

Some mutual funds allow the investor to invest their units from one scheme to another and this flexibility is a great boon to investors. This gives investor opportunity to make investment as per the changing situation in the market.
2.12.8 Greater affordability and liquidity

Even a very small investor can afford to invest in mutual funds. They provide an attractive and cost effective alternative to direct purchase of shares. Again there is greater liquidity as units can be sold to the fund at any time at the net asset value and thus quick access to liquid cash is assured.

2.12.9 Record keeping

Investor is not over burdened with the task of record keeping. The investor has to keep a record of only one deal with the mutual fund. Even if he does not keep a record, the MF sends statements very often to the investors.

2.12.10 Supporting capital market

The savings of the people are directed towards investments in capital market through these mutual funds. Mutual funds also provide a valuable liquidity to the capital market, and thus the market is made very active and stable.

2.12.11 Promoting industrial development

All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures. The mutual funds not only create a demand for these capital market instruments but also supply a large source of funds to the market.

2.12.12 Numerous options

Mutual funds invest according to the underlying investment objective as specified at the time of launching a scheme. So, we have equity funds, debt funds, gilt funds and many others that cater to the different needs of the investors. The availability of these options makes them a good
option. While equity funds can be as risky as the stock markets themselves, debt funds offer the kind of security that aimed at the time of making investments. Money market funds offer the liquidity that desired by big investors who wish to park surplus funds for very short-term periods. Hence investment in mutual fund is subject to the need and objectives of the investors. As it offer a wide variety of products for different categories of investors. For example equity funds are a good bet for a long term, they may not find favor with corporate or High Net worth Individuals (HNIs) who have short-term needs. Thus after having discussed about the benefits of investing in mutual funds let us have a look at investment in mutual funds in comparison to other avenues of investment as shown in table 2.2.

**TABLE 2.2**

Comparison by Nature of Investment

<table>
<thead>
<tr>
<th></th>
<th>RETURN</th>
<th>SAFETY CONVINCENCE</th>
<th>VOLATILITY</th>
<th>LIQIDITY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EQUITY</strong></td>
<td>High Moderate</td>
<td>Low</td>
<td>High</td>
<td>High or Low</td>
</tr>
<tr>
<td><strong>FI BONDS</strong></td>
<td>Moderate High</td>
<td>High</td>
<td>Moderate</td>
<td>Moderate</td>
</tr>
<tr>
<td><strong>CORPORATE DEBENTURE</strong></td>
<td>Moderate Low</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Low</td>
</tr>
<tr>
<td><strong>COMPANYFIXED DEPOSITS</strong></td>
<td>Moderate</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td><strong>BANK DEPOSITS</strong></td>
<td>Low High</td>
<td>High</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td><strong>PPF</strong></td>
<td>Moderate High</td>
<td>High</td>
<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td><strong>LIFE INSURANCE</strong></td>
<td>Low Moderate</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td><strong>GOLD</strong></td>
<td>Moderate Low</td>
<td>High</td>
<td>Moderate</td>
<td>Moderate</td>
</tr>
<tr>
<td><strong>REAL STATE</strong></td>
<td>High Low</td>
<td>Moderate</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td><strong>MUTUAL FUNDS</strong></td>
<td>High</td>
<td>High</td>
<td>Moderate</td>
<td>High</td>
</tr>
</tbody>
</table>

Source: Researcher’s own compilation
2.13 The Disadvantage of Mutual Fund

2.13.1 No Guarantees

No investment is risk free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. Investors encounter fewer risks in mutual funds than when they buy and sell stocks on their own. However, anyone who invests through a mutual fund runs the risk of losing money.

2.13.2 Fees and commissions

All funds charge administrative fees to cover their day-to-day expenses. Some funds also charge sales commissions or "loads" to compensate brokers, financial consultants, or financial planners. Even if funds don’t use a broker or other financial adviser, investor will have to pay a sales commission if they buy units in a Load Fund.

2.13.3 Taxes

During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If a fund makes a profit on its sales, investor will have to pay taxes on the income they receive, even if they reinvest the money.

2.13.4 Management risk

When an investment is made in a mutual fund, it returns depend on the fund's manager ability to make the right decisions regarding the fund's portfolio. If the manager does not make right decision there are chances that the investor will not get desired return. Therefore the funds manager plays a crucial role in generating returns. In mutual fund also
there is certain amount of risk-return factor associated according to the
investment option as shown in table 2.3 below.

Table 2.3
Risk and Return of Mutual Fund

<table>
<thead>
<tr>
<th></th>
<th>Risk</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Balanced</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Debt</td>
<td>Low</td>
<td>Low</td>
</tr>
</tbody>
</table>

Source: Researcher’s own compilation

2.13.5 No tailor-made portfolio

The portfolio of a fund does not remain constant. The extent to
which the compositions of the portfolio will change depends upon the
style of the individual fund manager. It is also depends on the volatility of
the fund size i.e. whether the fund constantly receives fresh subscriptions
and redemptions. Portfolios changes have to bear the cost of brokerage,
custody fees, registration fees etc. that lowers the portfolio return
commensurately.

2.14 Risk Involved in Mutual Fund

Mutual funds investment is subject to market risks. As mutual funds
investment is made primarily in the capital market they are subject to
various kinds of risks. The following are some of the risks associated with
the investment in mutual funds.
2.14.1 Market Risk

The net asset values of mutual funds may rise and fall dramatically which may be due to prevailing market conditions. This is known as market risk.

2.14.2 Credit Risk

The debt servicing ability (may it be interest payments or repayment of principal) of a company through its cash flows determines the Credit Risk faced by the company. This credit risk is measured by independent rating agencies like CRISIL who rate companies and their paper. An ‘AAA’ rating is considered the safest whereas a ‘D’ rating is considered poor credit quality.

2.14.3 Inflation Risk

Inflation is the loss of purchasing power over time. Many times people make conservative investment decisions to protect their capital but end up with a sum of money that can buy less than what the principal could at the time of the investment. This happens when inflation grows faster than the return on investment.

2.14.4 Interest Rate Risk

In a free market economy interest rates are difficult if not impossible to predict. Changes in interest rates affect the prices of bonds as well as equities. If interest rates rises the prices of bonds fall and vice versa. Equity might be negatively affected in a rising interest rate environment.
2.14.5 Political/ Government Policy Risk

Changes in government policy and political decision can change the investment environment. They can create a positive environment for investment or vice versa. Thus the growth and development of mutual funds depends to a large extent on the policy of the government.

2.14.5 Liquidity Risk

Liquidity risk arises when it becomes difficult to sell the securities that one has purchased. Liquidity Risk can be partly mitigated by diversification, staggering of maturities as well as internal risk controls that lean towards purchase of liquid securities.

Conclusion

Mutual funds have undergone significant changes both quantitative as well as qualitative since its inception in 1822 in Belgium. The present chapter was dedicated to trace the evolution of mutual funds as financial instruments for investment. It has also dealt with concept and working of mutual fund industry in India, classification of various types of mutual funds schemes and the advantages and disadvantages of investing in mutual funds. The next chapter is devoted to find out the evolution of the mutual fund industry in India, various issues and challenges, regulatory framework, role of mutual funds in mobilization of household sector savings and the impact of liberalization on the net resource mobilization by the Indian mutual funds.
References

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51. *Ibid*