INTRODUCTION

1.1. Meaning and Definition of Investment

1.2. Purpose of Investment in KDMC Region

1.3. Meaning & Definition of Investor

1.4. Various Investment Avenues Available in KDMC Region

1.5. Sources to Collect Information in KDMC Region

1.6. Concept of Mutual Fund

1.7. Advantages & Disadvantages of Mutual Fund

1.8. Risks Involved in Mutual Fund

1.9. Mutual Fund & Stock Market

1.10. Structure of Mutual Fund Company
1.1. Meaning and Definition of Investment:
Investment involves employment of funds with the aim of achieving additional income or growth in values. Investment is a commitment of funds in real assets or financial assets. There are various avenues of investments in accordance with individual preferences. Investments are made in different asset classes depending on individual’s risk and return characteristics. Investment choices are physical assets and financial assets. Gold, Commodities and Real estate are examples of physical assets, which have a physical form.

Financial assets are securities, which are certificates embodying a financial contract between parties. Bonds, Equity shares, Deposits and Insurance policies are some of the examples of financial assets. In financial assets investors only hold the proof of their investments in the form of a certificate or account. These products are usually liquid, transferable and in most cases, stored electronically.

Investment involves risk and gain. In the present dynamic global environment, exploring investment avenues are of great relevance. Investment skills developed over a period of time are considerably influenced by experience and work carried out to arrive at conclusions. The success of an investment activity depends on the knowledge and ability of investors to invest, the right amount, in the right type of investment, at the right time. Financial assets available to individual investors are manifold, having different committing benefits to choose from. All financial investments are risky but the degree of risk and return differ from each other. An investor has to use his discretion, which is an art acquired by learning and practical experience. The knowledge of financial investment and the art of its management are the basic requirements for a successful investor. The pre requisite for successful investor also lies in its liquidity, apart from risk and return on investment.

Dictionary of Economics and Commerce defines investment as “a financial terms it refers to the purchase of stock exchange securities or Government securities issued through the post office or deposit of money in society, or banks or other financial assets will best satisfy his needs of institutions with the aim either of securing an income or the refund of a greater sum at some future date.”
Nature of Savings & Investments:
Capital formation is essential factor for socio-economic transformation. Capital formation depends on mobilization of saving. Greater saving, greater capital formation and greater material assets provide financial base for economic development. Savings is the excess of income over the consumption and expenditure or is the difference between income and expenditure. Saving is always substantially influenced by the increase in personal income and the disposable income.

Investment is the infusion of fund in productive work with the aim of achieving additional income or growth in value. When fund is infused in the productive work or in the financial assets or securities it takes some time for reward. It involves the commitment of resources which have been saved or put away from current consumption in the hope that some benefits will accrue in future. Investment involves long term commitment. Investors are the suppliers of capital and according to their view investment is commitment of person’s funds to derive future income in term of interest, dividend, rent, premium, pension benefit or the appreciation of the value of their principal amount.

Wise investment of personal saving necessitates a clear understanding of objectives of saving. Every investment channel can be viewed as a package offering a unique combination, which fulfils the objectives of : (i) principal value, (ii) expected income, (iii) ease of converting principal into cash, and (iv) tax consequences. Each outlet has a greater or lesser degree of uncertainty associated with each factors.

Investment is the process of putting money to work to earn income. Investing even a small amount can produce considerable growth over long period. Investors continuously plan for their investments to fulfill major needs like financial protection, career building, asset purchase, marriage, children’s’ education, retirement funding etc. For this investors need to take decision regarding, how much to invest? Where to invest? To choose wisely, investors need to know investment options thoroughly. It is financial services institutions and intermediaries which help the investors for transforming saving into investment, production and growth. It is a mechanism or arrangement for the mobilization of funds, their transfer and allocation. A financial services intermediary and has enormous value in the financial market.
1.2. Purpose of Investment in KDMC Region:
Birth, childhood, graduation, early employment, Marriage, children education, marriage of children and retirement - these are the life phases that people normally go through. The asset allocation and investment choices that all are made would need to keep the life cycle in mind.

Thus in the early stages of one's professional career the investment mix would be emphasizing more on the secured investments with higher returns. But choice for investment mix towards retirement would be more income oriented. The objective behind an investment is to maximize the returns and hedge against the inflation with minimum risk. Every investor tries to achieve this objective by selecting the different investment avenues which suits his purpose for investment. And the residents of KDMC region are also not exception to this. The different purposes for which an individual invests are given below:

1. To Grow Money:
If the money is kept only in the form of saving without investing it, it won’t grow. Investing savings can only give growth to money. Most investment vehicles, such as stocks, certificates of deposit, or bonds, offer returns on your money over the long term. This return allows your money to build, creating wealth over time which can be used for different purposes at different stages of life cycle.

2. To Assure Financially Safe and Secure Retirement:
In the young age and middle age an individual is able to earn the money for old age. While working he can save money for financially safe and secure retirement life. Therefore generally an individual put his retirement savings into a portfolio of investments, such as stocks, bonds, mutual funds, real estate, businesses, or precious metals. Then, at retirement age, he can live off funds earned from these investments.

3. Earn Higher Returns:
In order to grow money, an individual need to put it in a place where it can earn a high rate of return. The higher the rate of return, the more money can be earned. Investment vehicles tend to offer the opportunity to earn higher rates of return than
savings accounts. Therefore, to earn a higher return on money, an individual has to explore different investment avenues.

4. Reach Financial Goals:
Investing can help you reach big financial goals. If money is earning a higher rate of return than a savings account, one will be earning more money both over the long term and within a faster period. This return on investments can be used towards major financial goals, such as buying a home, buying a car, starting own business, or children’s education.

Thus it can be observed that an individual invests with different purposes. Investment helps to prepare for future. Nobody wants to work their entire life. Investing is one good option that you can secure your future. Well, one can earn money in two ways by working or by having assets which work for them. One of the main reasons to invest is that if the savings are kept idle with investing it, it doesn't work for you. And over a period the value of savings will decrease with the increase in inflation. Thus investing the money will generate more money by earning interest or capital appreciation or profit by buying and selling assets. This will increase the value of savings and can be used for different needs.

1.3. Meaning & Definition of Investor:
Investor is an individual who puts his savings in different investment products with the expectation of financial return. Generally, the primary concern of an investor is to minimize risk while maximizing return, as opposed to a speculator, who is willing to accept a higher level of risk in the hopes of collecting higher average profits. An investor allocates funds with the expectation of a future financial return. The savings can be put in different investment options such as - equity; debt securities, real estate, currency, commodity, and derivatives such as put and call options, etc.

Accounting Dictionary defines the term investor as “An investor is an entity that commits money to a venture with an expectation of generating a return. The type of commitment made can be in many forms, such as a guarantee to pay creditors, a loan, an equity investment, tangible assets, or even the contribution of labor. An investor typically makes a commitment in exchange for either a fixed return (such as
dividends or interest) or the prospect of being able to sell its investment to a third party at a later date for a higher price than the amount of the original investment.”

Every investor is different, with different financial goals, different tolerances to risk, different personal situations and different desires. These characteristics itself becomes the objectives and constraints while taking the investment decision. Two investors with the same characteristics may have very different financial choices. And the main reason for this is their propensity for risk, not their innate characteristics. Thus the investors select the different investment avenues according to their high, medium or low propensity for risk, within their particular balance of personal characteristics.

While risk profiling is a highly subjective exercise, it can safely be said that appetite for Risk reduces with:

- Age;
- Increasing dependents;
- Reduction in earning members;
- Any serious health related issues in the family; and
- Job insecurity.

On the other hand a person would be inclined to make more risk when:

- Major expenses are taken care of, For instance, when the investor has his own house and loans are repaid;
- Other major aspirations are met or provided for;
- The investor is a professional whose income streams are on the upswing; and
- Investor has hit the jackpot.

Risk profiling exercise would result in suggestions on how an investor should distribute his portfolio between different investment avenues.

1.4. Various Investment Avenues Available in KDMC Region:

It is very necessary for investors to know different types of investment available in the market. There are different investments avenues with different risk and return levels. An understanding of the core concepts and a thorough analysis of the various types of
investment can help the investor to make the right choice. There are two broad investment alternatives which are available to investors in KDMC region. Direct investment alternative and indirect investment alternative which are as follows.

1.4.1. Direct alternatives:
There are fixed and variable investment alternatives under direct investment.

A. Fixed Investment Alternatives:
In fixed investment alternative, term and growth of investment is fixed for specified period and interest rate. These alternatives are as follows:

a) Investment in Banks:
Investment in banks is considered as the safest of all options, banks have been the foundation of financial system in India. Promoted as the means of social development, banks in India have played an important role. For investment, banks offer various accounts, ‘term deposit’ having varied maturity and varied interest rates.

b) Post Office Savings:
The Government of India has design small saving schemes to provide an attractive and safe investment options to public. These schemes are operated through post offices and hence called as Post Office Saving Schemes. It includes PPF, NSC (National Saving Certificate), Post Office Saving Account, Post Office Time Deposit Scheme, KVP (Kisan Vikas Patra), Monthly Income Scheme, Senior Citizen Saving Scheme, Sukanya Samriddhi Account. All these schemes are very safe and also give different benefits under Income Tax Act.

c) Government Bonds:
Investments in Government Bonds have a wide network of distribution spread across the nation. Government offers different investment avenues through post offices and mobilizes the savings. An investment in this avenue is considered safe as the investment is backed by Government of India.

d) Corporate Bonds:
Another mostly used alternative of investment is corporate bonds where investment is
made directly in company deposits. In India, this alternative of investment is not popular.

e) Preference Shares:
This type of investment is called fixed interest bearing securities. The preference shareholders are entitled to claims for dividends before ordinary shares. This type of investment is not suitable and popular in small investors’ segment.

B. Variable Investment Alternatives:
Variable investment alternatives are different from the fixed investment alternatives because their terminal values are not known with certainty. The alternatives of variable investment are as follows:

a) Equity Shares:
Investment in equity shares has no fixed growth. These are called variable investment alternatives. Due to this investment, investors can participate in the earning and wealth of the company. Investors receive dividends as income on equity shares.

b) Convertible Debentures:
Convertible debentures can be converted into ordinary shares at the option of the shareholders after certain number of years. Income on these types of investment is not fixed. Generally, this type of investment is not favorable among small investors.

c) Gold:
Gold is preferred by investors as a hedge against inflation. Gold does not suffer value erosion on account of currency depreciation. Investment in gold can be done in different forms such as:

- Buying gold in physical form
- Buying gold in commodity future markets
- Buying gold linked funds
- Buying gold exchange traded funds
**d) Real Estate:**

Investment in real estate mean buying property in the form of open land or units constructed residential or commercial buildings. Real estate is preferred by the investors but is beyond the means of small investors because the capital required is large and transaction cost may be high. It is also not easy to quickly liquidate investments in real estate at an appropriate price. Still the investors with long term investment objectives can earn good return from the real estate investment.

**e) Commodities:**

A popular way to invest in commodities is through a futures contract, which is an agreement to buy or sell, in the future, a specific quantity of a commodity at a specific price. Futures are available on commodities such as crude oil, gold and natural gas, as well as agricultural products such as cattle or corn. Other alternatives to invest in commodities are stocks and exchange traded funds.

1.4.2. **Indirect Investment Alternatives:**

Indirect Investment alternatives include pension fund, provident fund, insurance and mutual funds. Individuals have no control over these investments. Investors entrust the work of investment to other institutions. On behalf of investors, financial institutions invest the funds, generate growth and distribute to the investors.

**a) Public Provident Fund:**

It is a risk free investment as it is backed by Government of India. Moreover the interest received is not taxable. The investment also gives the benefit tax saving under section 80C of Income Tax Act. PPF account can be open in banks or post offices. PPF has tenure of 15 years, though the withdrawal can be made before 15 years subject to certain conditions.

**b) Insurance:**

Though the returns in life insurance are lesser, still they protect the family of beneficiary in case of death of beneficiary and / or also help in case of critical illness and hospitalization of beneficiary. The maturity value of insurance, in case of term insurance is also not taxable and at the time of investing, it gives benefit under section
80C of Income Tax Act. The Term Insurance can be used to raise the loan without much hassle. Hence, because of these varied benefits, insurance is the most preferred investment options though the returns are less.

c) Mutual Fund:
The investors those who has less risk appetite but wish to take benefit of volatile market conditions, for them Mutual Fund is a good investment option. Mutual Funds pool the money from public and utilize it in diversifying securities. Different types of schemes are available as per the need and attitude of the investor. It helps the investors to generate better inflation adjusted returns. Mutual Fund Industry is well regulated and come under the purview of SEBI. It also gives the tax benefits.

Every asset class implies a risk-return tradeoff. Generally one has to take a greater risk for a chance to earn a higher return. The AFMI Mutual Fund Testing Programme Workbook provides a useful comparison of investment alternatives:

**Table No. 1.1: Comparison of Investment Alternatives:**

<table>
<thead>
<tr>
<th>Investment Alternatives</th>
<th>Return</th>
<th>Safety</th>
<th>Volatility</th>
<th>Liquidity</th>
<th>Convenience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>High or Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>Bonds</td>
<td>Moderate</td>
<td>High</td>
<td>Moderate</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Company Debentures</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Company Fixed Deposit</td>
<td>Moderate</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>Bank Deposits</td>
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<td>High</td>
<td>Low</td>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>PPF</td>
<td>Moderate</td>
<td>High</td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Life Insurance</td>
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<td>Low</td>
<td>Moderate</td>
</tr>
<tr>
<td>Gold</td>
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<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>High</td>
<td>High</td>
<td>Moderate</td>
<td>High</td>
<td>High</td>
</tr>
</tbody>
</table>
1.5. Sources to Collect Information in KDMC Region:

A common investor is always confused while deciding the investment avenues as these days hundreds of options are available for investment. At the same time is investment body try to convince about how their investment option is best suitable to the investor. In such a situation the investor normally rely on one of the other sources available to him, while taking the investment decisions. The general sources which are available to the investors in KDMC region are:

1) Expert's Opinion:

Before a person makes an investment, it is important that they acquire complete information about the different avenues. And normally a common investor like that much time and energy required to collect the whole updated information. Hence, many a time an investor depends on expert's opinion. The experts are having more knowledge and information than a common investor.

2) Market Trends:

Those investors who can analyze and interpret the different financial information published by different investment organization and financial agencies rely on the market trends which they can understand on the basis of analysis. Such investors are having the basic knowledge and expertise to understand the volatile market trends and are able to collect the required information on their own for deciding the suitable investment option.

3) Advertisements:

The different financial institutions gives widespread advertisement in newspaper, TV channels, financial reports, etc which gives, gives complete information about the investment scheme launched by the institute which helps the investor to decide whether the particular avenue suits his requirement or not and accordingly he takes the decision.

4) Consultants:

Consultants are the experts in the field of investment decision. Consultant studies and compares the different investment options and can guide the investor about best option available for his needs. Thus an investor instead of studying and analyzing the
different investment options relies on the consultant for collecting the required information.

5) Past Performance:
When investors already decide in which investment option he has to invest, he studies the past performance of that investment and then takes the decision. Generally the investors who do not want to try the newly launched investment avenues go for the investments which are already there in the market. In case of such investments information about the returns given and risks associated with it can be known and a fair estimate about the future performance can be made.

6) Family/Friends Advise:
When the investors are having any relatives or friends in their circle who are having expertise in the field of finance and investment, they prefer to take their advice for investment. Because for them such family members and friends are the most trusted source of information. Investors take their advice and then select the investment avenue.

1.6. Concept of Mutual Fund:
The word ‘mutual’ denotes something to be done collectively by a group of people with the common objective. ‘Fund’ is used in the monetary terms, to collect some money from the members for a common objective of earning profits with joint efforts. Mutual Fund concept refers to a fund, managed by an asset management companies with the financial objectives of generating growth. After collecting the money from investors asset management companies this money in different stocks, bonds and other financial securities in a diversified manner. A detailed study is carried out before investing, and detailed analysis is done on the market conditions and market trends of stock and bond prices.

It helps the fund manager to invest properly and in a right direction. Investors are given an equity position in mutual fund in which they invest their money. When after certain period of time, whether long term or short term, the investors sell the shares of the mutual fund, they receive the growth according to the market conditions. The investment companies allocate the money received from investors in different stocks...
and bonds according to their study about the market trend and earn profit on that. Investors generally sell the units of their mutual funds at any time they want. But the growth will vary according to market value of the stocks and bonds in which that particular mutual fund made investment. Generally, the shareholders of mutual fund sell their shares when the prices are up and “capital gain” is sure to happen.

As defined in the pamphlet of the Association of Mutual Funds in India (AMFI), “A mutual fund is a trust that pools the savings of a number of investors who share common financial goal. Anybody with an investible surplus of as little as a few thousand rupees can invest in mutual funds. These investors buy units of a particular mutual fund scheme that has a defined investment objective and strategy”.

According to the Securities and Exchange Board of India (SEBI) (Mutual Fund) Regulations 1993, “Mutual funds means a fund established in the form of a trust by a sponsor to raise monies by the trustees through sale of units to public under one or more schemes for investing in securities in accordance with these regulations”.

The analysis of the above mentioned definitions and descriptions reveals the following main attributes of mutual funds:

- Mutual Fund gathers scattered small saving into a common fund of sizable amount.
- Funds collected by mutual funds are invested in securities of different companies.
- Mutual funds employ experts for professionalized portfolio management.
- Due to diversified portfolio, the risk is spread out and a stable return for an investor becomes possible.
- The earnings of mutual funds are distributed amongst the investors after deducting the management costs.

A mutual fund is a corporate body registered with Securities Exchange Board of India (SEBI) that pools money from individuals and corporate investors. This collected money is invested in a variety of different financial instruments or securities such as equity shares, bonds, debentures government securities, etc. Mutual funds act as
financial intermediary in the investment business which collect funds from the public and invest on their behalf. Mutual funds issue units to the investors. The value of units held by the investors gets increased with the appreciation in the portfolio or securities in which the mutual fund has invested the money.

**Figure 1.1 Working of Mutual Fund**

The mutual fund outlines the investment objectives in its prospectus which become binding on the mutual fund scheme. The investment objectives specify the class of securities in which a Mutual Fund can invest in. Mutual funds invest in various asset classes like equity, bonds, debentures, commercial paper and government securities. The schemes offered by mutual funds vary from fund to fund. Some schemes are purely equity schemes which invest in equity shares only and the others are a mix of equity and bonds. Investors are also given the option of getting dividends, which may be declared periodically by the mutual fund, or to participate only in the capital appreciation of the scheme.

Thus mutual fund is an institutional device through which investors pool their funds to invest in a diversified portfolio of securities, and thereby spreading and reducing risk under the investment skill of an investment manager. The income generated by selling securities or capital appreciation of the securities is passed on to the investors in proportion to their investment in the scheme. The unit holders share the income earned through these investments and the capital appreciations realized in proportion
to the number of units owned by them. A mutual fund’s business is to invest the collected funds, according to the need of the investors. In mutual fund markets, these wishes are articulated as ‘investment mandates’. From the above explanation, mutual fund has following characteristics.

- A Mutual Fund belongs to the investors who have pulled their funds. The ownership of mutual fund is in the hands of the investors.

- Investment professionals earn a fee for their services from the fund manager for managing the mutual fund.

- The pool of funds is invested in a portfolio of marketable investments. The value of the portfolio is updated every day.

- The investor's share in the fund is denominated by 'units'. The value of units changes with change in the portfolio’s value, every day. The value of one unit of investors is called as the net asset value or NAV.

- The investment portfolio of the mutual funds is created according to the stated investment objectives of the fund. Thus a mutual fund is most suitable investment for the common man as it offers an opportunity to invest in a diversified professionally managed basket of securities at a relatively low cost.

Mutual Funds are essentially investment vehicles where people with similar investment objective come together to pool their money and then invest accordingly. Each unit of any scheme represents the proportion of pool owned by the unit holder (investor). Appreciation or reduction in value of investments is reflected in Net Asset Value (NAV) of the concerned scheme, declared by the fund from time to time.

Mutual Fund Schemes are managed by respective Asset Management Companies (AMC). Different business groups, financial institutions and banks sponsors these AMCs either alone or in collaboration with other firms. Mutual funds invest according to the underlying investment objective specified at the time of launching the scheme.
So, investors have equity funds, debt funds, gilt funds and many others that cater to the different needs of the investors. Equity funds are as risky as the stock markets themselves, debt funds are for very short term periods. Balance funds cater to the need of investors having an appetite for risk greater than debt funds but less than the equity funds. The only relevant factor here is that the fund has to be selected keeping the risk profile of the investor because the products have different risks associated with them.

1.7. Advantages & Disadvantages of Mutual Funds:
Every coin has two sides and Mutual Fund is also not an exception to this rule. There are certain advantages as well as disadvantages for investment in Mutual Funds. They are discussed below.

**Advantages of Mutual Funds:**
Mutual Funds are advantageous to individual investors in relation to their direct involvement in investment portfolio activity covering the following aspects:

**A. Risk Spreading:**
Diversification is almost universally acclaimed by the investment advisors and academic researchers who have found that there is virtually no value added by holding only a limited number of stocks when a person invest in a mutual fund he appreciates in a large basket of shares of different companies and industries which are included in the fund’s portfolio. Without spending considerable time and money, small investors can enjoy the facility of diversification. Fund diversification also reduces and spreads the risk factor of investors. The fluctuations of the stock markets have less impact over the mutual funds. A fall in the price of a few scripts will not affect them much.

**B. Skilled Management:**
Through mutual funds, the investors get the expertise of professional money managers. Professional managers can easily tackle the purchase and sell without giving pain of paper work to the individual investors. The trained, skillful, professional management of mutual funds can successfully select a stock portfolio and change as per changed circumstances. The stock market is a very technical area.
which lures an average investor but inexperienced hands may soon burn their fingers. The mutual fund provides the benefit of skilled portfolio management to the small investor, who otherwise cannot afford such expertise or knowledge.

C. Automatic Reinvestment:
In mutual funds it is possible to reinvest the dividends and capital gain, while it is difficult for the individual investors to reinvest the dividend and capital gain. This revolving type of investment makes possible forced saving for the investors which can make a big difference in the long run.

D. Flexibility:
Except some of the Mutual Funds, many mutual funds are having flexibility. Any time the investor can redeem or diverse the mutual fund scheme. The Mutual funds having locking period also get such flexibility a stipulated period. On expiry of this period, the investor can easily change the portfolio by selling particular units. In this way, he can reinvest the money where he finds lucrative return and less risk.

E. Liquidity:
Mutual funds are required by the SEBI to provide liquidity to investors. They are ready to buy back the units from the investors at the NAV on any day after the expiry of the initial lock in period. They announce through daily newspaper their repurchase price of units under the various schemes after regular intervals. Some mutual funds are also listed in various stock exchanges and can be sold off by the individual investors at the prevailing market price.

F. Encourage Systematic Investment:
Mutual Funds encourage systematic investment. Investors can choose Systematic Investment Plan to invest regularly, Systematic Withdrawal Plan to withdraw regularly or Systematic Transfer Plans to transfer money from one scheme to another.

G. Tax Shelter:
Income tax exemption has been ensured for mutual fund, while originally only such mutual funds as are set up by public sector banks or public financial institutions were exempt from tax. Now the benefit of tax exemption has been extended to all mutual
funds. Investors are eligible for deduction under section 80C of the Income Tax Act in respect of the dividends from units or share of mutual funds.

**H. Other Advantages:**
Apart from providing the above advantages, mutual funds also provide the following additional advantages:

a) Stable return,

b) Botheration free investment,

c) Developing saving habit, and

d) Safety because of government regulations.

**Disadvantages of Mutual Funds:**
Mutual Funds have emerged all over the world as a fact of economic life, but they are not free from limitations. Following are the notable disadvantages of mutual funds:

**A. MF has no Customized Portfolios:**
Mutual funds are standard products, managed centrally, offering significant advantages to investors who are not equipped to make complex investment choices. Investors do not exercise any direct control on how the portfolio is managed, but participate equitably in it. Customized portfolios are usually offered as Portfolio Management Services (PMS).

**B. MF Offers Too Many Product Variants:**
When so many variants of the same product are available in the market making a choice among many funds become tough for the investors. Mutual Funds try to vary their products, even if slightly, to provide a choice to customers. If these are similar in objectives and performance, investors may find it tough to differentiate the products and make the choice for their needs.

**C. High Management Cost:**
Mutual Funds have to incur substantial expenses to manage the investible funds to garner from investors. These include the salaries of the professional experts employed by the fund to manage it’s portfolio. The management costs of the fund are deducted from the total returns earned on the funds’ portfolio and only the balance is
distributed among the investors. This reduces the returns that would have otherwise been available to the investors had they managed their portfolios themselves.

D. High Promotional Expenses:
Cut-throat competition among the various mutual funds to mobilize the savings of the masses necessitates heavy promotional expenses. As estimated Rs. 1.5 crore is being spent on the promotion of every scheme launched by mutual funds in India. These expenses are likely magnified with the entry of more players in the mutual fund industry as the increase in competition would lead to heavier promotional expenses. This will further reduce the net returns which would be available for distribution among the mutual fund investors.

E. Flexibility:
Because of a fund holds many stocks, it may be difficult for it to unload its’ shares when the market goes down. Thus, by keeping money in a fund, the investor may have to ride the market down. On the other hand, there is no reason why his or her individual shares in the fund cannot be redeemed at any time. The share size of some funds reduces the flexibility to buy and sell as frequently and in as large volumes as the fund manager may prefer.

F. Redemption Cost:
Though the buyback arrangement offered by mutual funds does import liquidity to the investor’s portfolio, the price at which the shares are redeemed is net of redemption costs. Therefore, the considerations that the investors’ get in reduced on account of the redemption costs which are dedicated, making investment in mutual funds disadvantageous.

1.8. Risks Involved in Mutual Fund:
Mutual Funds can help to diversify investments to reduce risk. But, not all mutual funds are broadly diversified. Some are concentrated in a single industry, geographic region, or bond maturity range. That means they carry a higher degree of risk. On the other hand, these concentrated funds – or sector funds – may carry the opportunity of a greater return and may be appropriate as one of many holdings for an investor portfolio.
Investors' actual returns from Mutual Funds may differ from what they expected, based on the assessment of the product and the historical returns. This represents risk to the investors. Risk refer to the possibility that how a mutual fund product performs may vary from what was expected, and usually manifest in the volatility in the NAV. Higher the variance of the NAV from its average, greater the risk. The different types of risk an investors may come across are as follows:

A. Interest Rate Risk
Changes in interest rates – and in expected future interest rates – can cause the prices of some investments to risk of fall suddenly. When interest rates climb e.g., bond prices fall in lock step. The reverse is also true,. falling rates mean higher prices for bonds.

The prices of all types of investments reflects expectation about the future course of interest rates and thus to some extent are subject to interest rate risk. But the average investor is most likely to encounter interest rate risk in the bond market. If you buy a long term bond or bond mutual fund and interest rates rise, your investment will drop in value. Should rates fall on the other hand, you can expect to enjoy a profit as the investment gains value.

These price fluctuation can be dramatic. For example, if long term rates double, say from 7% to 14%, the value of your bond will be cut roughly in half. You can sell it, hope to recoup something to a capital loss, tax deduction and invest in a higher yielding security or you can hold on to it, collecting 7% on your investment at a time when the market rate is 14%.

How can you reduce your exposure to interest rate risk?
Pick a short term bond fund. They are hurt less by rising rates than long term bond fund. What if you want to increase your exposure to interest rate risk because you think rates are going down? Buy shares in a zero coupon bond fund. If you are right, rates fall, you will profit.

B. Credit or Default Risk
Credit risk arises from the default in payment of interest or principal, or both, by an
issuer of debt securities held in a mutual fund portfolio. A deterioration of the credit quality of the paper held by a fund will result in falling prices and net asset values.

Credit risk is assessed from the credit rating of a bond assigned by rating agencies such as CRISIL. A high credit rating indicates a low degree of default risk. AAA-rated bonds have less credit risk than A-rated bonds. Bond with rating below BBB are considered to be of speculative grade and risky.

The greater the credit risk, the greater the interest rate a borrower or issuer of securities must pay. As a result, mutual funds that invest in lower quality security offer higher yield than those that invest only in top quality obligation. In theory higher yield compensate investors who are willing to take on the higher risk of loss of principal if some issuers don’t repay and their bonds become worthless.

By investing in a corporate bond fund, one can get the kind of diversification that reduces exposure to the risk of one particular company defaulting on its obligations. To reduce risk further one should pick a fund that buys only the securities of big, highly rated corporations. Or by increasing credit risk, and potential return by buying shares in a junk bond fund or other type of fund that invests in low grade debt securities.

SEBI mandates an acceptable level of credit risk in mutual fund by stipulating that:

- A mutual fund should invest in instruments that are credit rated by agencies registered with SEBI.

- Investment in unrated Debt securities of one company cannot exceed 10% of the net assets of a scheme. Not more than 25% of net assets of a scheme can be in such unrated securities across issuer.

C. Market Risk:
Market risk is a standard risk in mutual fund products. Since Mutual Funds can invest only in marketable securities, and have to mark-to-market their investment portfolio every business day, the investors are exposed to the risk that a NAV and therefore
returns would vary with the variations in the market values. All mutual fund products are subject to market risks, the difference being only in degree.

Market risk in equity arises from changes in prices from changes in underlying fundamental and technical factors. As the market's expectation for the performance of the company changes the prices of stocks change, creating market risk to investors. In debt instruments changes in prices are triggered by changes in macro economic factors that change the market expectations for interest rates. Market risk in debt instruments is also known as interest rate risk. Changes in interest rates leads to changes in prices of issued debt instruments. Market risk is managed primary through diversification. Mutual Funds as a rule hold diversified portfolios of securities. SEBI mandates a minimum level of diversification in every mutual fund portfolio by stipulating that:

- Equity share in a single stock cannot exceed 10% of the net assets.
- Debt securities of a single borrower can not normally exceed 15% of net assets; with Trustee approval it can go up to a maximum of 20% of net assets.
- The Holdings of a mutual fund across all its schemes cannot be over 10% of the paid up capital of a single company.
- Mutual Funds cannot write an option or purchase instruments with embedded written options in them.

Some product structures enable managing market risk better. Liquid funds and other short term funds that invest in short term securities are not affected so much by changes in market prices. This is because they derive most of their NAV movement from interest income which is stable and a minor proportion of an NAV movement can be attributed to mark-to-market changes.

Mutual Funds are required to inform the investors that the changes in market prices of securities, in which the fund has invested, can impact the NAV and therefore cause risk. The standard disclaimer "Mutual Funds are subject to market risk; please read the scheme information document carefully before investing" is published along with all mutual fund advertisements and product literature. The risk factors associated with the scheme are published in the scheme information document.
Investors may form return expectations based on past performance, and therefore expect the same returns in the future. Since market risk may lead to actual returns being different from what is expected Mutual Funds have to mandatorily publish the disclaimer "Past performance may or may not be sustained in the future" in all their product advertisement and literature.

D. Liquidity Risk:
This is the chance that there will be no ready market for the investment if they are to be sold in a hurry. One of the chief advantages of mutual funds is the marketability. The units can be redeemed at any time at their NAV per unit. If it is sold, cash can be received for them in a few days, or even the next day if the fund company wire the proceeds from the sell directly into bank account. Moreover, mutual funds provide you with a way to invest directly in securities that would be less marketable if you bought them directly.

Because mutual funds must stand ready to repurchase units for cash, their managers must maintain adequate cash holdings and bank credit lines to handle redemptions by any fund holders who might be selling. Funds that invest heavily in less–marketable securities such as certain types of stock known as letter stock or restricted stock, could face problems if they are hit with a rush of redemption orders.

Even if the securities in the portfolio of a mutual fund is marketable, the market in which it is listed and traded may not offer a high level of liquidity, or the securities held by the fund may not be actively traded. This creates liquidity risk in the portfolio. Fund managers may need to liquidate some of the holdings if the market seems to be overvalued, or may need liquidity to meet the requirements to pay out redemption or dividends. Liquidity risk may not enable buying or selling easily as may be required, reducing the flexibility in managing the portfolio.

Funds that invest in small and mid Cap stocks may find it difficult to exit such stocks without impacting the price. Fund manager may also be wary of the growing size of a mid or small cap portfolio, since they may not like to invest too much in a single stock due to lack of liquidity; and they may not like to hold too many stocks which makes it tough to monitor the portfolio.
Secondary market in corporate bonds of lower credit quality are not very liquid; a fund holding a corporate bond which has been downgraded by rating agencies may find it tough to sell the bond. Mutual Funds also ensure liquidity in their portfolios by indicating in their asset allocation that they may hold liquid money market securities as required. This may reduce the return of the portfolio, but enable higher liquidity if the fund managers need it. Mutual Fund also reserve the right to temporarily stop redemption if they perceive higher illiquidity in the markets, to avoid selling the securities at a distress price. SEBI mandates an acceptable level of liquidity in a Mutual Fund by stipulating that:

Illiquid and thinly traded securities cannot be more than 10% of net assets in a closed end fund and not over 5% of net asset in an open ended fund.

To enable investors to judge the liquidity risk, such holdings have to be explicitly disclosed in the six monthly portfolio disclosures by the fund. In an extra ordinary situation, liquidity needs of a fund may be made from borrowings.

E. Measuring Risk:
Risk is defined as the variance of actual returns from expected returns. Since the simplest way to estimate expected returns is to use historical average returns, the standard deviation and variance can also be estimated along with the averages. We can use the NAV of mutual funds to compute a return series for the past. This return series can be used to estimate average returns and standard deviation for the fund.

1.9. Mutual Funds and Stock Market:
Mutual Fund is an emerging financial services intermediary and it has enormous value in the financial market. A mutual fund is recognized as a medium term as well as long term investment option. Mutual fund provides numbers of mutual fund options for savings and investment for meeting the needs of retail investors, foreign investors and local institutions. Mutual Funds are now playing a bigger role in promoting financial products. MF invest according to the underlying investment objective as specified at the time of a lunching a scheme. So, we have equity fund, debt funds, Gilt funds and many others that cater to the different needs of the investor. With the
entrance of new fund houses and the introduction of new funds into the market, investors are now being offered plenty of mutual fund choices.

If a mutual fund has tied up with stock exchanges for offering its units for purchase and redemption transactions through registered stock exchange brokers, investors can buy and sell units during the 9 a.m. to 3 p.m. when the stock exchanges are open.

The transactions are placed like orders to the brokers, and the contract note or transaction confirmation given by the brokers with an electronic time stamp by the trading system, is a valid acknowledgement. The first leg of transaction namely the receipt of funds for purchases and receipt of request for redemption are handled by the brokers and sent to the clearing Corporation. The second leg of the transaction namely the allotment of units against purchase and release of funds on redemption, is handled by the R & T agents. Documentation evidencing the transactions, with the folio details is sent to the R and T agents by the brokers. The transaction in units on stock exchanges only enables brokers to route to the investor transactions to the mutual fund, through their trading screens. These transactions are therefore not part of the settlement mechanism of the exchange and are not guaranteed by the exchange. The responsibility for completion of the transactions to the satisfaction of the investors lies with the AMC and the R and T agents. Transactions in mutual fund units on a stock exchange can be in physical or Demat form. In order to offer Demat services for its units the mutual fund has to tie up with a depository such as National Securities Depository Limited investors open a demat account with a Depository Participant (DP).

Demat transactions are settled through credit and debit instructions to the depository, by the Depository Participant of the investor. The statement given by the depository participants would be treated as the statement of account to the investor. The investor benefits from reduced paperwork and ease of transactions. The investor's details are maintained and updated by the depository and made available to all mutual funds.

The R and T agent receives a summary of transactions, provides information on the applicable NAV and recalculates the unit capital after the day's transactions are
settled. Units can be converted back into physical form from the Demat form through the process of re-materialisation.

The stock exchange is only a platform for distribution of units. Investors can use the redressal mechanism of the stock exchange to resolve complaint only pertaining to the transaction. Any dispute on settlement with respect to units has to be done using the usual process to handle investor grievances laid down by the fund.

Although reforms in the financial sector since 1991 have been successful in creating a competitive environment, the growth of mutual funds has slowed down, partly due to the problems faced by UTI.

Mutual Funds in India, because of their small size and slower growth in the recent past, have tended to play only a limited role in the stock market. In view of small size of their operations, mutual funds in normal times hardly exert any influence on the stock market. Nonetheless, major developments concerning mutual funds do exert significant influence on the sentiment. The negative developments at UTI such as reporting of negative corpus for US-64 in October, 1998, heavy redemption pressure on US-64 units in July, 2001 etc. resulted in decline in the BSE Sensex. On the other hand positive developments like implementation of special unit scheme and announcement of positive corpus for US-64 were associated with general uptrend in the equity prices.

Mutual funds with large funds at their disposal are expected by the government to act as a counterweight to Foreign Institutional Investors (FII), which generally exert a significant influence on the stock market.

1.10. Structure of Mutual Fund Company:
SEBI (Mutual Fund) Regulations, 1996 laid down the Structure to be followed by mutual Funds in India. The Sponsor creates the mutual fund and sets up the AMC. The mutual fund itself is structured as a Trust, as required by law. It is managed by the trustees in the beneficial interest of the unit holders. Trustees appoint the management company (AMC) to manage the fund. The following are the different stake holder in the structure of Mutual Fund Company.
1. Sponsor:

Mutual fund is promoted by the Sponsor, who sets up the Trust and AMC, appoints the Board of Trustees and Board of Directors of the AMC. The sponsor seeks regulatory approval for the mutual fund.

SEBI has laid down the eligibility criteria for a Sponsor. A Sponsor should:

- Have at least five years experience in the financial services industry.
- Have a good financial track record of at least three years prior to registration of the fund.
- At least 40% of the capital of the Asset Management Company is to be contributed by the Sponsor.

2. Trust:
The mutual fund itself is set up as a Trust. Investors in the mutual fund are the beneficiaries of the Trust. Sponsor appoints Trustees with SEBI approval, to act on behalf of the investors.

The Trust Deed is executed by the Sponsor in favour of the Trustees and it deals with the establishment of the Trust, the authority and responsibility of the trustees towards the unit holders and the AMC. SEBI has also laid down the clauses that have to form part of the Trust Deed.

Trustees can be an identified set of individual or a trustee company set up for the purpose. The Board of Trustees comprising of at least four members, (or the Board of Directors of the Trustee Company) oversee the working of the mutual fund. At least two third of the members of the board of trustees have to be independent of the sponsor.

The Board of Trustees has to meet at least six times in a year. Trustees are paid a fee for their services. There are aspects of general and specific due diligence, specified by SEBI, to be exercised by trustees, to oversee the working of the AMC and the management of the mutual fund. Several key decisions of the AMC with respect to managing the mutual fund require trustee’s approval.

3. Asset Management Company:
Asset Management Company (AMC) is the investment manager of the mutual fund and is responsible for running the day to day operations of the mutual fund.

The AMC is appointed by the trustees of the fund, in consultation with the sponsor and with the approval of SEBI. The rights and obligations of the AMC are specified in the Investment Management agreement signed between the trustees and the AMC. The AMC’s primary role is to manage the contributions from investors and take investment decisions.
SEBI’s regulations for AMCs require the following:

- AMCs should have a net worth of at least Rs. 10 crore at all times.
- At least 50% of members of the board of an AMC have to be independent.
- The AMC of one mutual fund cannot be an AMC or trustee of another fund.
- AMCs cannot engage in any business other than that of financial advisory and investment management.
- Statutory disclosures regarding AMCs’ operations should be periodically submitted to SEBI.
- Prior approval of the trustees is required, before a person is appointed as director on the board of the AMC.
- An AMC cannot invest in its own schemes, in normal course. If such an investment is being made, it has to be disclosed in the offer document of the scheme. The AMC will not be eligible for fees on such investments.
- The appointment of an AMC can be terminated by majority of the trustees, or by 75% of the unit-holders.

4. Fund Constituents:

The functional departments in typical AMC are: fund management, operations, sales and marketing, customer service, compliance, finance and accounts. Core functions in these areas are done in-house, while other functions may be outsourced to constituents who offer specialized services.

Mutual fund constituents (except custodians) are appointed by the AMC with the approval of the trustees. All mutual fund constituents have to be registered with SEBI. They are usually paid fees for their services. The following table lists the various constituents and their roles:

<table>
<thead>
<tr>
<th>Constituent</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Custodian</td>
<td>Hold and settle funds and securities</td>
</tr>
<tr>
<td>R &amp; T Agent</td>
<td>Keep and service investor folios</td>
</tr>
<tr>
<td>Banks</td>
<td>Enable collection and payment</td>
</tr>
<tr>
<td>Auditor</td>
<td>Audit Scheme accounts</td>
</tr>
<tr>
<td>Distributors</td>
<td>Distribute fund products to investors</td>
</tr>
<tr>
<td>Brokers</td>
<td>Execute transactions in securities</td>
</tr>
</tbody>
</table>
A. Custodians:
Custodians are usually large banks. They hold the cash and securities of the mutual fund and are responsible for their safekeeping and settle investment transactions using these funds and securities. Custodians are appointed by the sponsor. They represent the only constituent not directly appointed by the AMC. Custodians should be independent of the sponsor. The sponsor cannot appoint as custodians, entities in which they hold 50% or more of the equity capital; or have 50% or more of the board representatives as their nominees.
The custodian performs the following functions:
- Delivering and accepting securities and cash, to complete transactions made in the investment portfolio of the mutual fund.
- Tracking and completing corporate actions and payouts such as rights, bonus, offer for sale, buy back offers, dividends, interest and redemptions on the securities held by the fund.
- Custodian has to coordinate with the Depository Participants (DPs) which hold the securities account of the mutual fund schemes.
- Offering fund accounting and valuation services to mutual funds. (Some funds may prefer to manage this function in-house)

B. Registrar and Transfer Agents:
Registrar and Transfer Agents (R & T Agents) are primarily responsible for creating and maintaining investor records and servicing them. Investor records are kept in numbered accounts called folios. They accept and process investor transactions. They also operate investor service centers (ISCs) which act as the official points for accepting investor transactions with a fund.
R & T functions include:
- Issuing and redeeming units and updating the unit capital account.
- Enabling investor transactions such as purchase, redemption and switches.
- Creating, maintaining and updating investor records.
- Banking the payment instruments (Cheques and drafts) given by investors and notifying the AMC.
- Processing payouts to investors in the form of dividends and redemptions.
- Sending statutory and periodic information to investors.
C. Banks, Brokers and Auditors:
Banks provide collection and payment services to mutual funds. Investor cheques and drafts are collected into the mutual fund scheme accounts by banks. Banks are also involved in payment of redemption proceeds and dividends.

Auditors audit the books of the mutual fund. It is mandatory to keep the accounts of each mutual fund scheme separately. The auditors for the AMC’s accounts are distinct from the auditors of the mutual fund. Brokers execute the buy and sell transactions of the fund managers on stock exchanges.

D. Distributors:
AMC’s appoint distributors who sell the mutual fund products to investors. They are empanelled by a mutual fund and offered commissions on sale of the schemes. Distributors may work for more than one mutual fund. There is no exclusivity in mutual fund distribution.

The sponsor or an associate may act as a distributor for the fund with which they are associated. For example ICICI Bank is the sponsor of ICICI Prudential Mutual Fund and is also one of its distributors. Distributors may be individuals or institutions such as banks, non banking finance companies (NBFCs) or broking and distribution companies.

Individual distributors and employees of corporate distributors have to pass the certification examination mandated by SEBI and conducted by the National Institute of Securities Markets (NISM Series V A – Mutual Fund Distributors Certification Examination). They have to obtain an AMFI Registration Number (ARN) after clearing the examination, to empanel as distributors with a mutual fund. Distributors enable the reach of mutual fund products across geographical locations.

References:

• Uma Shashikant, Sunita Abraham, Arti Anand Bhargava, Understanding Mutual Funds, Tata Mcgrw Hill Education Pvt. Ltd. (Sept., 2010).