CHAPTER 1

INTRODUCTION TO THE STUDY

The Indian Economy is one of the fastest growing economies in the world and is set to emerge as the next economic super power in Asia next only to China by 2025. There is a need to re-emphasize on the basic infrastructure of the country to protect the economy and the interest of the large pool of investors. Creation of wealth is the primary objective of investors. There are a number of investment opportunities for the investor to achieve this. There are bank deposits, company deposits, equities, bonds, life insurance policies, small savings scheme, and mutual fund products etc. which create wealth, and also compete among themselves for the choice of the investor. However, a mutual fund is an ideal investment vehicle for today’s complex and modern financial scenario.

1.1 MUTUAL FUND: A CONCEPTUAL FRAMEWORK

Mutual Fund is a trust that pools the savings of a number of investors who share a common monetary objective. The money thus aggregated is then invested in instruments in capital market such as shares, debentures and other securities. Unit holder’s share their income acquired through these investments and its capital appreciations in proportion to the number of units owned by them. Thus a Mutual Fund is the most applicable investment for the common man as it offers (a) an opportunity to invest (b) diversified and professional managed basket of
securities (c) cost-efficient. The major advantage in investing in a mutual fund is diversity, minimum investment and liquidity.

Mutual fund is a financial institution that pools and professionally manages money from many investors. Generally, it allocates the money to equity, bond and cash instruments based on the investment objective. Other mutual funds types can invest in different sectors, real estate where it pools money from many investors who has the common objectives. A mutual fund is able to invest in diversified asset classes and diversified securities within an asset class more optimally than a single shareholder / unit holder. From the theory of risk, total risk can be divided into two components: systematic risk and idiosyncratic risk, the former is related to the market and the latter to the conditions of individual securities (Source: Investopedia).

With a diversification approach, the risk induced in a portfolio is reduced because idiosyncratic risks can be diversified, such that only the systematic risks remain. Although there is still discussion about how many securities are needed to form a diversified portfolio, a mutual fund has more capital and hence has more capabilities to invest in varied securities than a single shareholder who invests in mutual funds. Therefore, mutual funds have favored for investing in different portfolios. This makes it attractive for investment purposes in the investment avenues. According to the financial report by the Investment Company Institute in 2000 (source: Investment Company Institute and Bloomberg), mutual funds can be classified based on a level of risk and return as shown in Figure 1.1.
Figure 1.1 The Type of Funds Based on the Level of Risk and Return

A mutual fund that invests in equity, bonds or money market shares is called equity fund, bond fund or money market fund, respectively, whereas a balanced fund is a fund that allocates its money to both equity and bonds. An aggressive growth stock fund invests in high growth stocks. It focuses on capital appreciation and there is no income from dividends. A growth fund is similar to an aggressive growth fund, but the aggressive growth mutual fund aims to have higher capital gain by, for example, trading options. A growth and income stock fund invests in stocks with high growth rate and bonus which will be called as dividend. As opposed to an aggressive growth fund, dividend paying-stocks hold investment from an income fund.

Besides the classification elaborated above, mutual funds can also be classified as open-end or closed-end funds. Generally, the term “mutual fund” is the common name for what is classified as an open-end fund. It is called open-end because it sells every day and buys back fund shares from investors that wish to
leave the fund. A closed-end fund, on the other hand, has a limited number of shares that are available publicly. Usually, it also determines in advance the date when the value of the fund will be distributed among the shareholders.

In 1929, there were much more closed-end funds than open-end funds. The number of closed-end funds was about 700 while the number of open-end funds was about 20. However, after stock market crash (Great Depression) in 1929 the popularity of closed-end funds plummeted while the popularity of open-end funds surge. To regulate mutual funds and to protect the investors who invest in mutual fund, in 1933 the U.S. government formed the Securities and Exchange Commission (SEC). Every mutual fund in the U.S. should register to the SEC before its process which can be called as mutual fund operation process. In addition to SEC, there are group of people within a board structure of mutual funds who protect the interest of investors and inspect the fund from a criminal negligence.

In the U.S., maximum numbers of mutual funds are equity funds. From the whole amount of capital that is invested in mutual funds, equity funds hold about 50 percent of it, while money market holds 26 percent and about 18 percent investments are in bonds. In India, the industry has more than 44 players in the market and more than 800 schemes are available. The Indian mutual funds retail market is growing at a CAGR of about 30%.

The structure of a mutual fund was given by Investment Company Institute in the financial report 2000. A board of directors has the function to inspect the fund’s activities such as approving a contract with an investment adviser, a contract about the fees that are paid by shareholders, etc. The Board consists of about 40 percent of independent directors. An investment adviser maintains the capital of the fund based on its investment objective that is written in the prospectus. For example, if the investment objective is aggressive growth, the investment
adviser designates fund capital towards high growth stocks. Furthermore, to connect the fund with public shareholders, a distributor has a task to sell fund shares either to the public or through other firms. A custodian holds and maintains the asset of a fund to protect investor interest. Moreover, an autonomous public accountant inspects and certifies the mutual fund financial report, while a transfer agent processes the procedures to buy and redeem fund shares. The structure is shown in Figure 1.2.

1.2 THE HISTORY OF MUTUAL FUND

The first mutual fund was founded in the Netherlands. Called” Eendragt Maakt Magt”, implying ‘unity creates strength’, it was founded by a Dutch merchant and broker in 1774, Abraham van Ketwich, after the financial crisis from 1772 to 1773. The motivation was to provide diversification for small shareholders who invest their money in mutual funds. During this financial crunch, many British banks were bankrupt because of the over extension of their positions in the British East India Company. This crisis also affected many banks in Amsterdam. Studying the financial crisis, Van Ketwich realized the potential benefits of diversification.
To turn his idea into reality, Van Ketwich initiated some investors and invested the pooled money in banks, plantation loans in Central and South America, and bonds that were issued by the government of Austria, Danish, German, Spanish, Swedish, and Russia. Furthermore, this first trust already had a prospectus to document its behavior about, among others, the investment strategy, and portfolio construction, potential places for investments, management fees and payout policies.

It regulated the role of commissioners for monitoring the investment policy of the trust, and was assigned to a resource person who was responsible for daily administration. During this period to protect the investors, the first trust had also implemented regulations. For example, Van Ketwich was required to provide a yearly financial report to commissioners and to the professionals, investors and to interested parties. Furthermore, the life of this trust was limited to 25 years in which the value of the trust at the end of its life was liquidated and shared to all shareholders.

The pioneer of mutual funds already had a regulated mechanism similar to the regulations for closed-end funds today. After Eendragt Maakt Magt pioneered mutual funds in the Netherlands, in 1868 a foreign and colonial government trust was founded in London and this was the beginning of mutual funds in the Anglo-Saxon countries. The investments known as securities that were traded then are not the same as those that are traded in recent days. Mostly, the funds at that time invested in contracts of survival and for the loans on plantations.

There were two famous kinds of survival contracts, namely life annuities and tontines. A life annuity is a product having a feature where the lender received annual payment from the borrower and the latter paid the principal at the end of the contract. Now-a-days this mechanism is similar to a modern bond network. A mixed bag resembled life earnings, except that a tontine had a group of investors, instead of
an individual investor. In this contract, a borrower paid an annual amount to the group of investors. If some of the investors passed away, the same amount of payment was divided among the surviving investors. In addition to that, the borrower was required to give collateral to the investors. In 1875, in London there were already about 18 new trusts and in 1890s several mutual funds were established in the U.S. However, these mutual funds still published a limited number of units, which resembled the mechanism of closed-end funds. In July 1924, the first open-end fund was founded in the U.S. This fund was called Massachusetts Investors Trust and still exists today. As these types of funds were permitted to continuously issue and redeem units/shares, an open-end fund became more favorable among the investors. Hence, after the stock market crash in 1929 the number of open-end funds was increasing but the number of closed-end funds was decreasing.

During this period, the stock market experienced a difficult situation and hence some major legislative acts were implemented. By law, mutual funds were required to be registered in the SEC and followed the operating standards. Furthermore, mutual funds had to clarify their policies such as the structure in the institution, the fees, and the investment objective in the fund fact sheet which called the prospectus.

### 1.3 THE GROWTH OF MUTUAL FUNDS

According to Investment Company Fact Book 48th edition (2008) (Source: http://www.icifactbook.org/), the total net assets of the U.S. mutual fund industry grew from about US$ 17 billion in 1960 to about US$ 10,000 billion in 2006. These numbers show that mutual funds become popular and significant similar to investment tools, and hence become a fascinating subject for research. The growth of mutual funds is not surprising as there are several advantages in investing
in mutual funds. (i) The capital in a mutual fund is managed professionally. For example, the portfolio manager decides the portfolio or fund allocation. (ii) As discussed, above the investor enjoys the diversification benefits. Many investors pool their money in a mutual fund; the mutual fund can invest the pooled money in more diversified markets and sectors. Furthermore, depending on its investment objective, a mutual fund also diversifies based on security types. (iii) A mutual fund share is one of the investment avenues where investors can liquidate their investments and can trade it every business day based on the current or previous NAV value that it holds. (iv) Securities Exchange Commission (SEC) regulates the mutual funds. According to these regulations, mutual funds have to follow some operating standards, obey anti-fraud rules and disclose complete information to investors.

As a result, mutual funds are quite transparent and investors are protected against fraud. Despite these advantages, mutual funds also have disadvantages. (i) A mutual fund cannot follow a flexible investment strategy as a hedge fund. For example, a mutual fund is constrained to do short-selling. (ii) Investors are charged a fixed cost that is independent of how well or badly the fund performs. Although the mutual fund originated in Europe, the modern mutual funds grow faster in the U.S. Hence, at this stage, U.S. has the largest mutual fund market in the global as shown in Figure 1.3.

From Figure 1.3, it can be noticed that the U.S. has almost half of the total worldwide mutual fund assets while Europe has about one third of the total worldwide mutual fund assets. Other countries such as Argentina, Brazil, Canada, Chile, Costa Rica, and Mexico, in the American continent besides the U.S. have the smallest portion of the total worldwide mutual fund assets.
Furthermore, the equity funds hold more than half of mutual fund assets in the U.S., whereas the bond funds, the money market funds and the hybrid funds hold only 48 percent, 66 percent and 38 percent, respectively. Figure 1.4 demonstrates the detailed percentages of the different mutual fund types.

Figure 1.3 The Worldwide Mutual Fund Asset

Figure 1.4 The Type of US Mutual Fund
1.4 MUTUAL FUND INDUSTRY IN INDIA

The mutual fund industry in India started with the formation of Unit Trust of India, with the support and initiative by Government of India and the Reserve Bank of India in 1963. The history of mutual fund in India can be broadly classified into four distinct phases:

FIRST PHASE 1964 – 87

In 1963, by an Act of Parliament Unit Trust of India (UTI) was established. It was set up by the Reserve Bank of India and functioned under its regulatory and administrative control. The Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in phase of Reserve Bank of India. The first scheme launched by the Unit Trust of India was the Unit Scheme 1064. At the end of 1988, Unit Trust of India had Rs.6700 crores of assets under management.

SECOND PHASE 1987 –93

1987, marked the entry of non – UTI, public sector mutual funds set up by the public sector banks and the Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC). State Bank of India Mutual Fund was the first non-UTI mutual fund established in 1987 followed by Canbank Mutual fund (December 1987), Punjab National Bank Mutual Fund (November 1989), Bank of India (June 1990), Bank of Baroda Mutual Fund (October 1992).

Life Insurance Corporation established its mutual fund in June 1989, while General Insurance Corporation had set up its mutual fund industry during December 1990. Mutual fund industry had assets under management of Rupees 47004 crores at the end of 1993.
THIRD PHASE 1993 – 2003

With the entry of private sector funds in 1993, a new era started in the mutual fund industry, giving the Indian investors an ample choice of fund families. The year 1993 saw the first Mutual Fund Regulations come into being, under which all mutual funds were to be registered and governed except UTI Mutual Funds. The Kothari Pioneer was the first private sector mutual fund registered during July 1993. In the year 1993, SEBI Mutual Fund Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996.

The industry now functions under the SEBI (Mutual Fund) Regulations 1996. With the increase of number of mutual funds, many overseas mutual funds set up funds in India. The industry also witnessed certain acquisitions and mergers. At the end of January 2003, there were 33 mutual funds with total assets under management for Rupees 121805 crores. The Unit Trust of India with assets under management to the time of Rupees 44541 crores was way ahead of other mutual funds.

FOURTH PHASE

In February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities, one having the specifies undertaking of the Unit Trust of India with assets under management of Rupees 29835 crores as on January 2003, representing mostly, the assets of US64 scheme, assured returns and certain other schemes. The specified undertaking of UTI is functioning under the purview of the Mutual Fund Regulations.
1.5 ORGANIZATION STRUCTURE OF MUTUAL FUNDS

Mutual funds have organization structure as per the guidelines from Security Exchange Board of India. Security Exchange Board of India specified authority and responsibility of Trustee and Asset Management Companies with the objectives to control, promote, regulate, protect the investor’s right and ensure that efficient trading of units. The operation of a mutual fund starts with investors who save their money on mutual fund; the portfolio manager handles the funds and strategic investment on scrip. As per the objectives of particular scheme manager selected scrip’s, Unit value will become high when the fund manager investment policy generates the return on capital market. Unit return depends on fund return and capital market efficiency. Also it affects international capital market, liquidity and finally the economic policy. The flow diagram Figure 1.5 (a) and 1.5 (b) below indicates the process for the investors to gain returns. The Portfolio Manager has high responsibility inside of return and how to diminish the risk. When the fund provides high yield with high risk, investors are attracted to invest more funds for the same scheme.

Figure 1.5 (a) Flow Diagram of an investor to gain returns
The Mutual fund organization as per the SEBI formation and necessary formation is needed for sooth activities of the companies to achieve the desired objectives. The Transfer agent and custodian play role for dematerialization of the fund and unit holders hold the account holdings statement, but custody of the unit is on particular Asset Management Company. Custodian holds all the fund units on dematerialization pattern. Sponsor decides the responsibility of custodian when investor can purchase the fund, to redeem the unit.

Figure 1.5 (b) Flow Diagram of an investor to gain returns

1.6 TYPES OF MUTUAL FUNDS

A wide variety of Mutual Fund Schemes exists to provide the needs such as financial position, risk resilience, and return forecast etc. Figure 1.6 below gives an overview on types of schemes in the Industry.
1.7 ADVANTAGES OF MUTUAL FUNDS

Mutual funds are designed to provide maximum benefits to investors, and the fund managers have research teams to achieve the objectives of the schemes. To attain the market return, Assets Management Company has different sector fund types, which need proper planning for strategic investment.

The following are the significant advantages of mutual funds:

i. Portfolio Diversification

Mutual Funds invest in a well-diversified portfolio of securities which enables investor to holds a diversified investment portfolio (whether the amount of investment is big or small).
ii. Professional Management

The Portfolio Manager, through various research analyses has better investment management skills to ensure higher returns to the investor than what he can manage on his own.

iii. Less Risk

Investors acquire a diversified portfolio of securities even with a small investment in a Mutual Fund. Risk in a diversified portfolio is lesser than investing in other securities.

iv. Low Transaction Costs

Due to the economies of scale (benefits of huge volumes), mutual funds pay lesser transaction costs. These profits are passed on to the investors who invest in mutual funds.

v. Liquidity

An investor may not be able to redeem some of the shares held by him very easily and quickly, whereas units of a mutual fund are far more liquid.

vi. Choice of Schemes

Mutual funds provide investors with various schemes with different investment objectives / Plans / Options. Investors have the choice of investing in a scheme having a correlation between its investment objectives and their own financial goals or objective’s.
vii. **Transparency**

Funds provide investors with updated information pertaining to the markets and the schemes. All facts are revealed to investors as required by the regulator.

viii. **Flexibility**

Investors also benefit from the convenience and flexibility offered by Mutual Funds. Mutual Fund investors can switch their holdings from an equity scheme to a debt scheme and vice-versa. Option of systematic (at regular intervals) investment and withdrawal is also offered to the investors in most open-end schemes.

ix. **Safety**

Mutual Fund industry is part of a well-regulated investment environment and the interests of the investors are protected by the regulator. A complete transparency is forced and all funds are registered with SEBI.

1.8 **DISADVANTAGES OF MUTUAL FUNDS**

The mutual fund is not advantageous for the investor but also has disadvantages for the funds. The fund manager may not always make profits but might create loss by not properly managing the funds. The funds have a unique strategy for investment to hold, to redeem, to purchase unit at a particular time period.
The following are the disadvantages of mutual funds:

i. **Investor has no Control over Costs**

The Investor has to pay investment management fees and fund distribution costs as a percentage of the value of his investments (as long as the investor holds the units), irrespective of the mutual fund performance.

ii. **No Customized Portfolios**

The portfolio of securities in which a fund invests is a decision taken by the portfolio manager. The Investors don't have rights to interfere in the decision making process of a portfolio manager, some investors find it as a restraint in achieving their financial objectives.

iii. **Difficulty in Selecting a Advisable Mutual Fund Scheme**

Many investors find it difficult to select one option from the plethora of funds or schemes or plans available. For this, they may have to seek advice from Investment Advisors or financial planners in order to invest in the right fund to achieve their objectives.

1.9 **MUTUAL FUND AND CAPITAL MARKET**

Indian Institute of Capital Market (IICM) aims to educate and develop professionals for the securities industry in India and other developing countries, to create awareness among investors through research and training and to provide specialized consultancy related to the securities industry.
Capital market plays an important role for the growth of Mutual funds in India, and is divided into the two parts - the primary market and the secondary market. Primary market concerns with issue management, as per the mutual fund concern the primary called as the NFO (New Fund Offer), all the AMC (Assets Management Company) are issuing all the funds all the way through the NFO. Every NFO comes with particular investment objectives, style of investment and allocation of the funds, all depending on the fund manager’s style of investment.

1.10 ROLE OF SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

An index fund scheme means a mutual fund scheme that invests in securities in the same proportion as an index of securities. In accordance with the framework relating to short selling and securities lending and borrowing specified by the Board, a mutual fund may lend and borrow securities. Subject to the framework relating to short selling and securities lending and borrowing specified by SEBI, a mutual fund may enter into short selling transactions on a recognized stock exchange. Provided that in case of an index fund scheme, the advisory and investment fees shall not exceed three fourths of one percent (0.75%) of the weekly average net assets.

Provided further that, the total expenses of the scheme including the advisory investment fees, shall not exceed one and one half percent (1.5%) of the weekly average net assets in case of an index fund scheme. Every mutual fund shall buy and sell securities on the basis of deliveries and all cases of purchases, take delivery of relevant securities and in all cases of sale, deliver the securities, provided that a mutual fund may engage in short selling of securities in accordance with the framework relating to short selling and securities lending and borrowing specified by the Board, provided further that a mutual fund may enter into derivatives transactions in a recognized stock exchange, subject to the framework specified by the Board.
1.11 ROLE OF ASSOCIATION MUTUAL FUND IN INDIA (AMFI)

The Association of Mutual Funds in India (AMFI) is dedicated to developing the Indian Mutual Fund Industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders. Asset Management Companies in India has been shown in Table 1.1.

Table 1.1 Assets Management Companies in India

<table>
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<tr>
<th>S. No.</th>
<th>Name of Mutual Fund / Asset Management Company</th>
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<td>1</td>
<td>Axis Asset Management Company Ltd.</td>
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<td>44</td>
<td>UTI Asset Management Company Ltd.</td>
<td><a href="http://www.utimf.com">www.utimf.com</a></td>
</tr>
</tbody>
</table>

(Source: Money Control.com)

### 1.12 TAX PLANNING AND MUTUAL FUND

Investors in India prefer tax-saving mutual fund schemes for the simple reason that it helps them to save investments. As per section 88 of Income Tax Act, tax-saving mutual funds or the equity-linked savings schemes (ELSS) receive
certain tax exemptions. This is one of the reasons why the investors in India prefer the tax-saving mutual fund schemes as one of their investment avenues. There are several companies in India that offer tax-saving mutual fund schemes.

1.13 SEBI GUIDELINE ON MUTUAL FUND

In India, mutual funds play the role as investment with trust, some of the regulations laid down by the SEBI for setting up a mutual fund. Under the Indian Trust Act, 1882, as the part of trustee sponsor the mutual fund; the trustee company is represented by a board of directors. Board of Directors appoints the AMC and custodians. The board of trustees made relevant agreement with AMC and custodian. Through offer documents, the launch of each scheme involves inviting the public to invest in it.

Depending on objective of scheme, it may open for further sale and repurchase of units. In accordance with the nature of the scheme, it may be wound up after the particular time period.

1. The sponsor has to register the mutual fund with SEBI

2. To be eligible to be a sponsor, the body corporate should maintain a sound track record and have a reputation of fairness and integrity in all business transactions.

A Sound Track Record includes:

i. The body corporate should be in the financial services business for at least five years

ii. Having a positive net-worth in the five years immediately preceding the application of registration.
iii. Net-worth in the next preceding year more than its contribution to the capital of the AMC.

iv. Earning revenue in the three out of the five preceding years, including the fifth year.

3. The sponsor should hold at least 40% of the net worth of the AMC.

4. A party which is not eligible to be a sponsor shall not hold 40% or more of the net worth of the AMC.

5. The sponsor has to appoint the trustees, the AMC and the custodian.

6. The trust deed and the appointment of the trustees have to be approved by SEBI.

7. An AMC its officers / employees cannot be appointed as trustees of the mutual fund.

8. At least two thirds of the business should be independent of the sponsor.

9. For more than one mutual fund, only an independent trustee can be appointed as a trustee, such appointment can be made only with the prior approval of the fund of which the person is already acting as a trustees.

LAUNCHING OF SCHEMES

A Scheme has to be approved before its launch, by the trustees and a copy of its offer documents filed with the SEBI.

1. Every application form for units of a scheme is to be accompanied by a memorandum containing key information about the scheme.
2. The offer document needs to contain adequate information to enable the investors to make informed investments decisions.

3. All advertisements for a scheme have to be submitted to SEBI within seven days from the issue date.

4. The advertisements for a scheme have to disclose its investment objective.

5. The offer documents and advertisements should not contain any misleading information or any incorrect statement or opinion.

6. The initial offering period for any mutual fund schemes should not exceed 45 days, the only exception being the equity linked saving schemes.

7. No advertisements can contain information whose accuracy is dependent on assumption.

8. An advertisement cannot carry a comparison between two schemes unless the schemes are comparable and all the relevant information about the schemes are given.

9. All advertisements need to carry the name of the sponsor, the trustees, the AMC of the fund.

10. All advertisements need to disclose the risk factors.

11. All advertisements shall clarify that investment in mutual funds are subject to market risk and the achievement of the fund’s objectives cannot be assured.

12. No advertisement can be issued stating that the scheme has been subscribed or oversubscribed, when a scheme is open for subscription.
1.14 BARRIERS IN MUTUAL FUNDS IN INDIA

According to the report by KPMG [110] on Indian mutual fund industry: Distribution continuum - Key to success the following are the barriers in Mutual Funds:

i. Limited incentives for distributors for mutual fund products as compared to other financial products.

ii. Lack of product individuality and capability to communicate value to investors.

iii. Low act of entering and relatively lower addition of retail investors.

iv. Lack of mutual fund industry awareness among investors.

v. Emerging nature of industry regulations.

1.15 KEY CHALLENGES & OBSERVATIONS

KPMG report [110] focused on the key challenges and observations found in mutual fund industry as:

i. Distribution
   a. Portfolio managers haven’t demonstrated the inclination towards investing in their own distribution channel, and very much rely on the third party distributors / dealers.

   b. Dynamics of presenting the mutual fund products through third party channels is such that this growth comes at a cost, decreasing the profitability of the Asset Management Company – Hence Asset Management Companies try to strike a balance between aggressive growth and profitability.
ii. **Evolving nature of regulations and market environment**

   a. Constantly changing regulatory view to protect the investor and increase the reach of mutual funds and mutual fund growth.

   b. Regulations have made mutual fund distribution less attractive and have impacted the industry growth.

   c. Dynamic steps taken for manufacturers to ensure asset management can be a profitable business for newer players who are trying to gain scalability.

iii. **Investor mentality**

   India is still a relatively under penetrated market when it comes to paying for financial advice. Most investors are not happy paying a fee when it comes to receiving investment advice and even more so in years where the market sees greater volatility and when there may be potential losses on investments. In the past, High Net worth Investors who have the knowledge and wherewithal to appoint some advisors to manage their finances have paid for advice received.

iv. **Lack of investor awareness**

   Financial awareness and literacy of the average Indian investor is relatively low. Given the weakness of the investors from India to prefer savings in physical form like real estate, housing and gold, investments in Mutual fund instruments are relatively low compared to these other investment instruments. Mutual fund instruments constituted approximately 3% of Indian financial assets as opposed to gold and real estate which contributed approximately 46% of financial assets. Increasing awareness to promote mutual fund investment will remain a key challenge.
v. **Fog lines between the adviser and distributor**

While Securities and Exchange Board of India has tried to draw a line between consultants and dealers, there may still be some potential grey areas. Investors may not be aware of Advisory commissions. Furthermore, distributors also provide informal advice to investors, while receiving commissions from product manufacturers which are not in line with the regulations by SEBI.

### 1.16 PORTER FIVE FORCES MODEL FOR INDIAN MUTUAL FUND INDUSTRY

This model was developed by Michael. E. Porter [111] of Harvard business school in 1979. It has provided a frame work for business strategy and industry analysis. Force Analysis has been classified into five segments, namely:

a. **Negotiation Power of Suppliers**

b. **Bargaining Power of Customers**

c. **Intensity of Existing Rivalry**

d. **Threat of Substitutes**

e. **Threat of New Competitors**

#### 1.16.1 Negotiation Power of Suppliers

i. **Large number of alternate inputs**

When there are a large number of substitute inputs, suppliers have less negotiation leverage over the product owners. This is due to competition among alternatives. Greater competition positively affects Mutual fund industry in India. "Large number of substitute inputs (Mutual fund industry)" has a significant impact,
so an analyst should put more importance into it. "More number of alternate inputs (Mutual fund industry)" will have a long-term positive impact on the entity, which adds to its value. "Maximum number of alternate inputs (Mutual fund industry)" is a difficult qualitative factor to resist, so competing institutions will have an easy time overcoming it.

ii. **High competition among Distributors**

High levels of competition among dealers act to reduce prices to producers. This is a positive for Mutual fund industry in India.

iii. **Low concentration of Distributors**

A low concentration of distributors means there are many distributors with limited bargaining power. Low concentration of distributors positively affects Mutual fund industry in India.

iv. **Diversified distribution channel**

The more diversification of distribution channels become the less bargaining power a single distributor will have. This positively affects Mutual fund industry in India.

v. **Inputs have little impact on Expenses**

When inputs are not a big component of expenses, suppliers of those inputs have less bargaining power. Low expense inputs positively affect Mutual fund industry in India.
1.16.2 Bargaining Power of Customers

i. Investors require special customization

When investors require special customizations, they are less likely to switch to product owners who have difficulty meeting their demands. Investor customization positively affects Mutual fund industry.

ii. Low buyer price sensitivity

When buyers are less conscious to prices, prices can increase and investors will still buy the product. Inelastic demand positively affects Mutual fund industry.

iii. Low dependency on distributors

When produces have less dependence, sales distributors have less bargaining power. Low dependency positively affects Mutual fund industry.

iv. Product is important to customer

When customers cherish particular products they end up paying more for that one product. This positively affects Mutual fund industry.

v. Large number of customers

When there are large numbers of customers, no one customer tends to have negotiation. Limited bargaining leverage helps Mutual fund industry.

vi. Limited buyer choice

When investors have limited options they end up paying more for the options that are available. Limited buyer options are a positive for Mutual fund industry.
1.16.3    Intensity of Existing Rivalry

i.    Government controls competition

Government policies and regulations can dictate the level of competition within the industry, which is positive for mutual fund industry. “Government restricts competition” has a significant impact, so a research analyst on mutual fund should put more weightage into it.

Large industries allow multiple firms and products to prosper without having to steal market share from each other. Large industry size is a positive for Mutual fund industry and will have the short term impact

ii.    Fast industry growth rate

When industries are growing in income quickly, they are less likely to compete, because the total mutual fund industry size is also growing. The only way to grow in slow growth industries is to capture market-share from competitors. Fast industry growth positively affects Mutual fund industry

iii.    Low storage costs

When expense ratio and other storage costs are low, competitors have a lower risk of having to unload their inventory all at once. Low storage costs are a positive for Mutual fund industry.

1.16.4    Threat of Substitutes

i.    Substitute product is inferior

A secondary product means a investor is less likely to switch from Mutual fund industry to another investment instruments.
ii. **Substantial product differentiation**

When products and services are very different, investors are less likely to find their product or services that meet their needs. This is a positive for Mutual fund industry.

iii. **High cost of switching to substitutes**

Limited number of substitutes means that investors cannot easily switch / swap to other products or services of similar price and still receive the same benefits. High switching costs positively affect Mutual fund industry.

1.16.5 **Threat of New Competitors**

i. **High capital requirements**

High capital requirements mean a company must spend a lot of money in order to compete in the market. High capital requirements positively affect Mutual fund industry. "High capital requirements (Mutual fund industry)" has a significant impact, so an analyst should put more weight into it. "High capital requirements (Mutual fund industry)" will have a long-term positive impact on this entity, which adds to its value.

ii. **High sunk costs limit competition**

High sunk costs make it difficult for a competitor to enter a new market, because they have to commit money up front with no guarantee of returns in the end. High sunk costs positively affect Mutual fund industry.
The combined efforts of these forces find out the crucial profit potential of an industry. It helps to identify the crucial strengths and weaknesses of the firm or business. From the five force model a strategy maker can easily justify that which factor is the most influencing factor and it might be consider as opportunities or threats.

1.17 MUTUAL FUND INVESTING PROCEDURE

![Figure 1.7 Mutual Fund Investing Procedure]

Investor should decide on his / her investment objectives and financial goals. The investor should then discuss with the Investment Advisor or Financial Advisor on the future goals. Investment Advisor or Financial Advisor will help investors, by providing guidelines on the products which, helps the investors to achieve their goals and objectives. Application forms which are available with a brokerage house or asset management company should be properly filled. This
process can be also done online. The KYC form will be then verified and the Asset Management Company through Portfolio Managers along with other departments will invest as per the SEBI Regulations. Over a period of time, the stakeholders will enjoy the benefits of their investments. Stakeholders can also look into the independent portals to know about the fund performance details and the investors can do buy / sell transactions using these independent portals.

These portals have tie-ups with leading banks for seamless online payments. These portals will help investors to keep track of their holdings along with in-house research and analysis, which helps the investors to build the ideal portfolio.

1.18 STATEMENT OF THE PROBLEM

The expectations of investors play an important role, in the financial markets. They impact the price of securities, volume traded and the other financial operations. These are the expectations of influence by their perception and human beings relate the perceptions to actions.

Investor behavior is logical and internally consistent in various ways, however, this behavior does not always conform to such expectation norms. Much of the financial and economic theory is based on the general belief that individuals act rationally while selecting Investment Avenue and consider all available information in decision making process. However, there is no model which explains the influence of perception and beliefs on decision making and expectations.

Investor behavior may change from time to time, when all other influencing variables remain constant. To some extent investors can rely on the social psychology, to derive certain concepts to develop a model which help to
understand “Why and how” investors behave with certain pattern which can have managerial implications for the decision making at corporate level.

Measuring satisfaction of investors is most important for the Fund Operations in order to structure Mutual Fund Schemes or any other security, improve the service quality and retain the existing investors. There is a need to identify loyal investors and high net worth investors, recognize them by providing some sort of incentives and make them ambassadors of their products.

Identifying satisfied customer is complex, because satisfaction level and loyalty of investor’s change frequently based on the dividends offered by the competitors, attractive features of the schemes, investor relations maintained by the companies (Asset Management Companies), sustainability of companies during Crisis / Recession period, Liquidity and Marketability schemes of Investment Avenues, Entry/ Exit Load, hidden costs, changes in NAV value etc.,

This study evaluates the behavioral aspects of fund selection of individual investors; access the awareness level of investors and their satisfaction level towards services rendered by Mutual Fund Operators (Asset Management Companies) in Chennai City.

1.19 SIGNIFICANCE OF THE STUDY

Mutual fund is a growing industry and considered as the major mobilizer of financial resources for the stock market and the economy in general. The rapid growth of the mutual fund industry in India has attracted a number of private players into the market.
This study helps identifying the information needs of retail investors for making informed decisions with regard to investment in mutual fund products and its implications for web based marketing of mutual fund products in India.

i. This study attempts to study the gap between the Investors and the Asset Management Company.

ii. Whether the Investment Advisor helps the Investor by explaining all the features before investing? Is there a regular follow up taking place between Investment Advisor and Investor from Asset Management Company?

iii. Is the present form of fund related information adequate? investors are whether happy with the Mutual Funds provided by the Asset Management Companies?

The study has been undertaken on the Fund Selection Behavior of Investors in Chennai city and their Satisfaction Level towards Services Offered by Mutual Fund Companies.

1.20 NEED FOR THE STUDY

The rapid growth of the mutual fund industry in India has attracted a number of private players into the market. Formulation of alternative schemes by various mutual fund companies has therefore become important to fight the battle and to secure a sound position in the industry.

The various mutual funds’ companies have been successfully operating in the industry by providing a wide range of products to suit a variety of investors’ needs. Formulation of alternative schemes by various mutual funds companies has become important to fight the battle to secure a sound position in the industry.
There are various mutual fund schemes like Income, Growth, Equity, Balanced, Sector, Tax Saving Schemes, Equity Linked, Infra Structure, Gilt Funds etc., with different objectives and different investment pattern of funds. These create confusion in the minds of investors. The advertisements and other mode of communications being undertaken by various fund operators (Asset Management Companies) put the investors into a state of dilemma over the selection of a suitable scheme.

There could be some false advertisements schemes involving hidden costs and clear stated objectives material / information provided as caveats. All these put the investors into a trouble in their decision making. The awareness level about various schemes as per Age, Income, Risk taking ability, Period of Investment, Expected Return, Taxation, generally are not up to the expected level among the investors. This is due to unavailability of time to understand schemes and its features, insufficient communication, complexity in understanding Brochures and financial literatures, unavailability of well-equipped Investment Advisors, unavailability of experienced colleagues and friends in the field.

Fund Operators (Asset Management Company’s) have to do various services like communicating about the Fund Portfolio, provide Fact Sheets, Frequent disclosure of NAV, send e-Statements, prompt by pay Dividends and Returns etc., Satisfaction of customers towards services rendered by fund operators (Asset Management Company’s) at various stages is important.

If investors are not satisfied, loyalty cannot be expected and the businesses do not last long. Hence there is a need to study how investors behave while selecting different schemes, their awareness level and the level of satisfaction towards the services offered by the Asset Management Company’s (Fund Operators).
1.21 OBJECTIVES OF THE STUDY

The following are the objectives of the study:

[1]. To understand the savings objectives among Small Investors.

[2]. Find out the perception of investors towards Mutual Fund Product Awareness, Product Risks, Quality of Investment Advisors, Asset Management Company Reputation and Asset Management Company Services.

[3]. Find out whether Demographic characteristics of investors influence the mutual fund awareness level.

[4]. Find out whether there is relationship between the factors influencing the investors in mutual fund investment.

[5]. To develop a new business model for mutual fund industry using Structural Equation Modeling (SEM).

[6]. To develop a tool to predict the investment decision of investors using Fuzzy Logic.

[7]. To give suitable recommendations to the Mutual Fund Industry based on the findings.

1.22 SCOPE OF THE STUDY

The study relates to the attitude and behavior of the investors who are investing in Mutual Funds. The area selected for the study is Chennai City. The investors were identified with the help of financial advisors in mutual fund market. The study is restricted to Chennai only. This study confined only to retail lenders.
1.23 OPERATIONAL DEFINITION AND CONCEPTS

**Mutual Fund** is a fund established in the form of a trust by a sponsor to raise money by the trustee through the sale of units to the public under one or more schemes for investing in securities in accordance with the SEBI regulations.

**Mutual Fund Scheme** refers to the IMFI products launched representing a category with specific objective and varied options. A scheme can belong to open or close-end type of operation. The objective of the scheme can relate to any category like income, growth, balanced, money market and equity linked savings scheme.

**Open-End Funds** are schemes of a mutual fund offering units for sale on a continuous basis directly from the fund and does not specify any duration for redemption or repurchase of units.

**Net Assets Value** is the current market worth of a mutual fund scheme. Calculated on a daily basis considering total assets and any accrued earnings, after deducting liabilities; the remainder is divided by the number of units outstanding. NAV is considered as the most reliable indicator of mutual fund performance. Basically NAV is refers to the price of the unit of the mutual fund and is calculated as: This is the performance indicator for a mutual fund scheme. On can buy the units of the mutual funds at the prevailing NAV plus the entry load as applicable

**Unit** means the share of holding of an investor in a mutual fund scheme. Each unit represents one undivided share in the assets of a scheme.

**Unit-Holder** is a participant in a mutual fund scheme.

**Growth Schemes** invest primarily in shares and also might hold fixed-income securities in a smaller proportion.
Growth Option of a mutual fund scheme is an option for long term growth of resources mobilized as it invests primarily in shares with significant growth potential. Dividend is not paid to the investors but ploughed back into the fund increasing the NAV of the units.

Year refers to the financial year of Government of India starting on April 1 and ending on March 31 of the following year.

Asset Management Company - A Company registered with SEBI, which takes investment/ divestment decisions for the mutual fund, and manages the assets of the mutual fund. Kotak Mutual Funds, SBI Mutual Funds, ICICI Prudential Mutual Funds etc. are the various Asset Management Company's in the country.

Asset Allocation - Involves the allocation of the total corpus or fund available with the Mutual Funds to different class of assets like equities, bonds, derivatives etc. The asset allocation is done in keeping the objective of the scheme into consideration.

Transfer Agents - Professional firms which maintain the records of unit holders of the AMC.

Entry Load - When an investor purchases units of the mutual fund scheme an initial amount charged by a fund for its administrative expenses or for paying commissions to brokers. This charge is termed as the entry load. Entry load is levied as a percentage of NAV.

Exit Load - When an investor wants to withdrew his or her money back from the fund, a kind of redemption charge that the investor is required to pay. The idea behind the levy of such charges is to discourage investors from making an exit from the fund. Exit load is levied as a percentage of NAV.
**Expense Ratio** - It is the ratio of total expenses to net assets of the fund. Total expenses include management fees, the cost of shareholder mailings and other administrative expenses. A low expense ratio means that the fund is able to maintain the fund at low expenses. As the size of the fund increases, the expense ratio decreases.

**Rating** - Every security in the financial market is subject to risk or in fact a plethora of risks. It is very difficult for an investor to evaluate risk. There are certain agencies engaged in providing credit rating to the securities issued by the various issuers. The rating is done specific to the security. Crisil, Icra, Care are some of the credit rating agencies.

### 1.24 LIMITATIONS OF THE STUDY

The following are the limitations of the study:

i. Sample Size is limited to 334 educated individual investors from Chennai.

ii. Simple Random Sampling techniques are due to time and financial constraints. Due to ups and downs of the stock market conditions which a significant influence of investor’s buying pattern and preference, the study has not been conducted over a period of time.

iii. The Performance Analysis doesn’t cover the impact of mergers and takeovers of the sample schemes.

iv. Respondents are not ready to discuss their full investment details due to many factors.

v. Lenders are classified on the basis of their investment i.e. small investors only.
vi. The variables included in the assessment of lenders behavior in the mutual fund market is fully based on the review and experts view.

vii. Data analysis is subjected to the limitations of various statistical analyses.

viii. The INSIGHT model for next generation mutual fund industry is designed by considering only six factors namely Investor Awareness / Services, Intention to invest, Streamline Cost, Investment Advisor Needs, High Distribution Network Model, and Technology Usage.

ix. Performance analysis of various mutual funds is calculated using Treynor ratio, Jenson’s alpha, Sharpe and beta ratios. The techno Portfolio advisor predict the investment decision of investors using Fuzzy Logic considering the parameters such as investor age, return rate and goal.

1.25 CHAPTERISATION SCHEME

This study is organized into seven chapters. The present chapter covers an introduction to the research study and includes a statement of the problem, objectives of the study, conceptual frame work, issues, and statement of assumptions, need and limitations of the study.

Chapter 2 is a review of the relevant literature for the study. Various aspects of mutual funds are covered.

Chapter 3 presents the research design of the study in detailed. This chapter includes the identification of the sample, its size, research approach, the research instrument, pilot study, data collection method, questionnaire, pretest, reliability analysis and statistical tools used for the study.
Chapter 4 analyses the collected data and details them.

Chapter 5 deals with building a next generation mutual fund model and comparing the efficiency of the model with Structural Equation Modeling (SEM).

Chapter 6 convenes with the designing of a tool for an investor to choose the optimal mutual funds for investing.

Chapter 7 highlights the findings, conclusions, review of the results, answers for the research questions and limitations of the research. This is followed by the appendices and references.