CHAPTER 2

CONCEPT AND HISTORY OF MUTUAL FUNDS

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CHAPTER 2

CONCEPT AND HISTORY OF MUTUAL FUNDS

2.1. CONCEPT OF MUTUAL FUNDS

The concept of mutual funds was conceived to mobilize savings from the people and invest them in a mix of corporate and government securities. The mutual fund operators actively manage this portfolio of securities and earn income through dividend, interest and capital gains, which is eventually passed on to the fund holders.

Mutual funds are dynamic financial institutions which play a crucial role in an economy by mobilizing savings and investing them in the capital market, thus, establishing a link between savings and the capital market. A mutual fund is a special type of institution which acts as an investment conduit. It is essentially a mechanism of pooling together the savings of a large number of investors for collective investments with an avowed objective of attractive yields and appreciation in their value. It is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is ‘mutual’ as all of its return minus its expenses, are shared by the fund’s investors.

“Mutual Fund—also called Unit Trust or Open Ended Trust— a company that invests the fund of its subscribers in diversified securities and in turn issues units representing shares in those holdings. They make continuous offering of new shares at net asset value and redeem the shares on demand at net asset value determined daily by the market value of the securities held” (New Encyclopedia Britannica, 1994)\(^1\).

Encarta Encyclopedia defines mutual funds as form of management Investment Company that combines the money of its shareholders and invests those funds in a wide variety of stocks, bonds and money market instruments (Singh, 2006)\(^2\).

Thomson Dictionary of Banking defines a unit trust ‘as a method of investment by which money subscribed by many people is pooled in a fund, the investment and management of which is subject to the strict legal provision of trust deed. The fund is invested in securities on behalf of subscribers by a management company. The management company and the trustee who must be independent of each other are
parties to the trust deed which defines their respective responsibilities towards the subscribers to the trust fund and details the rules for the operation of the trust.” (Bansal, 1996)³

Mutual fund is a synonym for an investment company in USA and an investment trust in UK and other European countries. Reilly (1982)⁴ has defined Investment Company as “a pool of funds belonging to many individual that is used to acquire a collection of individual investments such as stocks, bonds and other publically traded securities.” According to Michael(1987)⁵, “A mutual fund is a professionally managed investment company that combines the money of many people whose goals are similar and invests this money in a wide variety of securities.”

To Pierce (1984)⁶, “mutual fund is a non-depository or nonbanking financial intermediary, which acts as an important vehicle for bringing wealth holders and deficit units together indirectly”.

As per the Mutual Fund Fact Book (1995)⁷, “A mutual fund is a financial service organization that receives money from shareholders, invests it, earns returns on it, attempts to make it grow and agrees to pay the shareholder cash on demand for the current value of his investment.”

The Securities & Exchange Board of India {Sec. 2(m), 1993}⁸defines a mutual fund as a “fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments.”

To sum up, mutual fund is a financial intermediary established in the form of a trust sponsored by banks, financial companies and other industrial concerns with an objective to mobilize savings (mostly household) by launching various schemes and investing the pooled savings in various instruments of capital and money market.

Exhibit 2.1 depicts the operation flow chart of mutual funds. It is very clear that mutual funds collect money from the investors. The fund is invested in various securities through fund managers, which generates return and finally the return is passed back to the investors.
2.2. CHARACTERISTICS OF MUTUAL FUNDS

On the basis of the above definitions of mutual funds, the following characteristics of mutual funds can be listed:

i. **Common Fund**: Mutual Funds collect scattered small savings into a common fund of sizeable amount.

ii. **Fund Mobilization**: Mutual funds provide an opportunity to small investors to invest their money in industries which is not possible otherwise. By way of fund mobilization activities from large number of persons, mutual funds are able to collect a big sum which later on is available to industries and other economic activities.
iii. Professional Management: Mutual funds employ experts for professionalized portfolio management. Thus, investors are getting the benefit of expert financial management services.

iv. Diversification of Risk: Mutual funds invest the collected funds in diverse securities such as equities, debentures and bonds of various companies. The investments are made in fixed and assured return securities as well as money appreciating securities. Thus the diversification of investments is helping the investors to minimize the risk and maximize the returns.

v. Disclosure of Facts: Mutual funds disclose all relevant facts concerning the fund and the schemes launched regularly. The most important disclosure is the net asset value (NAV) of various schemes.

vi. Sharing of Return to Investors: The earnings of mutual funds are distributed among the investors in proportion to their holdings after adjusting the operating expenses.

2.3. ADVANTAGES OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. In fact, there is revolutionary change in the mutual fund industry in view of its importance to the investors in general and the country’s economy in particular. Some of the important advantages of mutual funds are stated below:

a. Professional Management

Mutual funds offer professional management as they are managed by professional managers who have the requisite skills and expertise to analyze the performance and prospects of companies. They make possible an organized investment strategy, which is hardly possible for an average investor who lacks the knowledge of investment management.

b. Diversification of Risk

Investment involves an element of risk. However, risk can be diversified by investing in mutual funds. Mutual funds invest in a wide variety of securities of a number of companies. This diversification reduces risks because seldom
do all stocks decline at the same time and in the same proportion. Thus, the investor obtains a proportion of the average market.

c. **Liquidity of Investment**

The Securities and Exchange Board of India (SEBI) requires that mutual funds in India have to ensure liquidity. Thus, mutual funds provide easy liquidity to those who want to dispose of their units after a stipulated period of time. The open ended mutual funds offer instantaneous liquidity through repurchase facility. Close ended schemes also offer the facility of repurchase after a specified period in addition to listing on the stock exchanges.

d. **Flexibility**

Mutual funds offer a variety of schemes and investors have the option of transferring their holdings from one scheme to the other. Moreover, the investments of mutual funds are generally tradable at stock exchange. Therefore, whenever an investor wants to sell his investment he can do so easily.

e. **Convenience**

Investment in mutual fund is easy and convenient. This is because of the fact that investing in a mutual fund reduces paper work compared to other investment avenues and thus, helps to avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual fund investments save time and make investment easy and convenient.

f. **Transparency**

Mutual funds offer transparent services. They provide regular information on the value of investment in addition to disclosure on the investment made by the scheme, the proportion invested in each type of security and the fund manager’s investment strategy and outlook. Thus investors know the status of their investment and if they are not happy with the portfolio, they can withdraw at a short notice.
g. **Low Operating Costs**

Mutual funds having large investible funds at their disposal avail economies of scale. The brokerage fee or trading commission may be reduced substantially. Thus mutual funds are a relatively less expensive way to invest compared to directly investing in the capital market and the reduced operating costs obviously increase the income available for investors.

h. **Safe Investment**

As mutual funds are supervised by expert fund managers, investment in mutual funds provides safety. Besides this, the legislation of any country (like SEBI in India) also provides for the safety of investment. Mutual funds are required to follow the laid down provisions for their regulation. Thus investors' interest is safeguarded.

i. **Tax Benefits**

Mutual funds offer the benefit of tax exemption to the investors. In India these tax benefits are provided under sections 80 L and 88 of the Income Tax Act and also under Wealth Tax Act. Under section 88, for equity linked schemes mutual funds, tax rebate up to 20% of investment is available. Under section 80 L dividend income for mutual fund is tax exempted. Under the wealth Tax Act, investment in mutual funds is exempted up to Rs. 5 lakhs.

j. **Shareholders Services**

Mutual funds offer many useful services to shareholders like automatic reinvestment, retirement plans, and record keeping for tax purposes. In mutual funds, it is possible to reinvest the dividends and capital gain. Many funds have systematic withdrawal plans for retired individuals.

k. **Better Yields**

The pooling of funds form a large number of customers enables mutual funds to have large funds at its disposal. Due to these large funds, they are able to buy cheaper and sell dearer than the small and medium investors. They are
able to command better market rates and lower rates of brokerage. So they provide better yields to investors.

I. Providing Research

Each Mutual fund maintains a research team which constantly analyses the companies and the industries and recommends the fund to buy and sell a particular share. Thus, investments are made purely on the basis of a thorough research. Since research involves a lot of time, efforts and expenditure, an individual investor cannot take up this work. By investing in a mutual fund, the investor gets the benefit of the research done by the mutual fund.

2.4. DISADVANTAGES OF MUTUAL FUNDS

Though mutual funds are helping the small household investors and also in the development of the economy, but they have certain defects. The major defects are listed as under:

a. Promotional Cost

Mutual funds involve high promotional cost. As and when the private sector entered the mutual fund industry, cut-throat competition emerged. All the players of mutual funds are spending huge sum on advertisement, paying high commission to agents and such other promotional expenses. As a result of high promotional cost, the return of investors decreases substantially.

b. Managerial Cost

Generally, mutual funds are managed by professional experts. For this purpose, mutual funds employ experts of financial management at high salaries and perks, which is ultimately borne by the investors by way of reduction in their return.
c. Operational Cost

The operational cost is very high in mutual fund because mutual fund’s business require big establishment to operate their activities. It increases the cost of operation and decreases the return of investors.

d. Redemption cost

In respect of some mutual fund schemes, the investors get buyback facility after some time. But the instruments are redeemed after deducting the cost of redemption. This reduces the realizable price of the instrument.

e. Ignoring Guidelines Hit Investors

In the absence of any specific Act for mutual funds, in India, these are operated on the basis of guidelines issues by the SEBI, the Ministry of Finance and the Reserve Bank of India. But it is found that many mutual fund operators are not following these guidelines. The non-compliance of guidelines affects the interest of investors adversely.

2.5. CLASSIFICATION OF MUTUAL FUNDS SCHEMES

In the investment market, there are investors with different needs, objectives and risk-taking capacities. Any one type of mutual fund scheme will not suit the requirements of all investors. Hence, to meet the varied needs of investors, various types of schemes are launched by the mutual fund organizations from time to time.

The various types of mutual fund schemes may be classified as follows:

A. Operational Classification
   1. Open-ended Scheme
   2. Close-ended Scheme
   3. Interval Scheme.

B. Portfolio Classification
   1. Income Funds
   2. Growth Funds
   3. Balanced Funds
4. Bond Funds
5. Stock Funds
6. Index Funds
7. Industry Funds
8. Tax Relief Funds
9. Leveraged Funds
10. Real Estate Funds
11. Liquid Funds
12. Gilt Funds
13. Load or No-load Funds
14. Systematic Investment Plan (SIP)
15. Systematic Withdrawal Plan (SWP)
16. Retirement Pension Plan (RPP)
17. Insurance Plan (IP)

C. Geographical Classification:
1. Domestic Funds
2. Offshore Funds

D. Structural Classification:
2. Money Market Mutual Funds.

E. Others:
1. Equity Linked Savings Scheme (ELSS)
2. P/E Ratio Fund
3. Exchange Traded Funds
4. Fund of Funds
5. Floating Rate Funds
6. Derivatives Arbitrage Funds
7. Fixed Maturity Plan
8. Capital Protection Schemes
9. Gold Exchange Traded Fund
10. Specialized Funds
11. Dual Funds
A. Operational classification

1. Open-ended Scheme

The open-ended funds have a perpetual existence and their corpus is ever-changing depending upon the entry and exit of members. Under this scheme, the size of the fund and / or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time at NAV-related prices. The basic objective of open-ended schemes is liquidity. Some examples of open-ended schemes are UTI'S US-64 scheme, LIC Dhansahyog 91, LIC Dhanvridhi 89, GIC Fortune 94 etc.

2. Close-ended scheme

Such schemes have a definite period after which their shares/units are redeemed. Under this scheme, the corpus of the fund and its duration are prefixed. After the subscription reaches the pre-determined level, the entry is closed. After the expiry of the maturity period, the entire corpus is disinvested and the proceeds are distributed to the holders in proportion to their holding. Master Share 86 of UTI, Can Bonus 91, IndRatna 1990 etc are some examples of close ended schemes.

3. Interval Schemes

Such schemes possess the characteristics of both open-ended and close-ended schemes. They are open for sale or redemption during pre-determined intervals at NAV-related prices.

B. Portfolio Classification

1. Income funds

The prime aim of income funds is to generate and distribute regular income to the members on a periodical basis. Under this scheme, funds are generally invested in income-oriented instruments like bonds, debentures, government securities and commercial paper. It concentrates more on the distribution of
regular income and it also sees that the average return is higher than that of other investment avenues.

2. Growth funds

The objective of such funds is capital appreciation. Here the corpus is mainly invested in equity shares with high growth potential and they offer higher return to investors in the long run. They are also known as ‘Nest Eggs’ or ‘Long Haul’ investments. Such funds involve moderate to high risk for the investors and reflect aggressive investing by them.

3. Balanced Funds

Such funds aim at providing regular income as well as capital appreciation. The portfolio of such funds is a mix of equity and bonds. Such funds put more emphasis on equity share investments when the outlook is bright and will tend to switch to debentures when the future is expected to be poor for share. Their exposure to risk is moderate and they offer a reasonable rate of return. The NAVs of such funds are likely to be less volatile compared to pure equity funds.

4. Bond funds

Such funds have their portfolio consisted mainly of fixed income securities such as debentures and bonds. These funds meet the need of those investors who expect a regular income and not ready to bear high risk. Obviously risk is low in such funds.

5. Stock Funds

Such funds are meant for those investors who are willing to take high risk in the hope of high return. The assets held in the fund are entirely the common stocks of diversified list of industries.

6. Index Funds

Index funds aim at investing funds in those shares, which are included in the stock market indices. The portfolio of such funds reflects the composition of
some broad based market index. The value of such funds goes up when the market index goes up and vice versa.

7. Industry Funds / Sectoral Funds

Such funds invest its financial resources in some particular industries / sectors with high growth potential like steel, power banks, insurance, etc. such funds carry high risks and gains as the performance of these funds is directly exposed to a specific sector.

8. Tax Relief Funds (TRFs)

Such funds aim at providing tax benefits to the investors. They are basically growth oriented funds. But it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates. Such funds are listed on stock exchanges. There would be a minimum lock-in-period of three years and the scheme shall not provide any type of liquidity during this period.

9. Leveraged Funds

These funds are also called borrowed funds. Here the size of portfolio of a fund is increased to the extent of borrowed capital. When the value increases, the earning capacity of the fund increases. The gains are distributed to the unit holders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds. Such funds are generally used in speculative and risky investments.

10. Real Estate Funds

In these funds, money is invested in those organizations which are involved in the activities of real estates. The return of the funds will be equal to the appreciation of estate value. These funds are of the close-end type. These funds are suffering from the defect of non-liquidity. They are much popular in UK and USA.
11. Liquid Funds

In liquid schemes, money is invested in short-term debt security with high liquidity. Here the emphasis is given more on liquidity than profitability.

12. Gilt Funds

They invest only in government securities. A portfolio of government securities is free of credit risk but it is exposed to interest rate risk. Income from such funds may be generated throughout receipt of coupon payments, amortization of the discount on the instrument and purchase/sale of securities in the underlying portfolio. The schemes also offer some capital appreciation.

13. Load or No-Load Funds

In the case of load funds, the offering price for a mutual fund is equal to the NAV plus sales charge/load. This charge is used for marketing and distribution expenses. An investor taking any investment decision in load funds should take into account the load as it affects the returns.

A no-load fund is one that does not charge for entry or exit. It means that investors can enter the fund at NAV and no additional charges are payable on purchase or sale of units.

14. Systematic Investment Plan (SIP)

Under SIP, investors can invest a fixed amount every month, for a predetermined period of time, usually 6 months to 1 year, through post-dated cheques at the applicable NAV-related prices. It helps investors to overcome the short-term fluctuations in the market.

15. Systematic Withdrawal Plan (SWP)

SWP allows the investors the facility to withdraw pre-determined amount/units from his fund at a pre-determined interval. The units will be redeemed at the existing NAV as on that day.
C. Geographical Classification

1) Domestic Funds

Domestic mutual funds mobilize resources from a particular geographical area like a country or a region. The market is united and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.

2) Offshore Funds

These funds enable NRIs and international investors to participate in the Indian capital market. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. In India these funds are subject to the approval of the Department of Economic Affairs. Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of offshore funds exist. ‘India fund’ and ‘India Growth Fund’ were floated by the UTI in UK and USA respectively. The SBI floated the ‘India Magnum Fund’ in Netherlands.

D. Structural Classification

1. Capital Market Mutual Funds (CMMFs)

In this case mutual funds invest the pooled resources in capital market instruments like shares, debentures and bonds.

2. Money Market Mutual Funds (MMMFs)

These funds are generally invested in money market instruments such as treasury bills, certificate of deposits, commercial papers, bills discounting etc. They are regulated on the basis of specified guidelines laid down by the RBI. Generally, the returns of such schemes fluctuate to a much lesser extent compared to other funds.

E. Others

1) Equity Linked Savings Schemes (ELSS)

Such schemes are open-ended, diversified, tax saving schemes with a lock-in period of three years. Under the schemes, investment is made in equity/equity related instruments for long-term capital appreciation. Returns in these schemes are linked to the returns of the stock market. They fall in the high risk and high return category. In India, an investment of up to Rs. 100000 in this scheme is eligible for deduction from the investors’ taxable income.
2) **P/E Ratio Fund**

This fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market. Broadly, around 90 percent of the investible funds will be invested in equity if the Nifty Index P/E ratio is 12 or below. If the ratio exceeds 28, the investment will be in debt/money markets. Between 12 and 28 P/E ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

3) **Exchange Traded Funds (ETFs)**

ETFs are index funds listed and traded on the stock exchange. They are a hybrid of open-ended mutual funds and listed individual stocks. They are basically passively managed funds that track a particular index such as S& P CNX Nifty. As they are open-ended and listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by market forces. Such funds can be bought and sold on the stock exchange prices that are usually close to the actual intra-day NAV of the scheme.

4) **Fund of Funds**

Such funds invest in other mutual funds and offer a return to investors. This scheme invests in a combination of equity and debt-funds. They are like hedge funds and they invest in other funds such as private equity funds and distressed assets funds. This enables the investors to obtain diversity in risk allocation. It provides the fund manager mere flexibility in allocating the investible corpus.

5) **Floating Rate Funds**

They invest in floating rate instruments. A floating rate instrument is one where the coupon rate is reset periodically to reflect the current interest rates. The coupon rate is linked to a benchmark rate which may be the over right call money rate or treasury bill rate. Floating rate instruments serve as an effective hedge against rising interest rate. With interest rates bottoming out and rise in inflation, floating rate funds are gaining popularity.

6) **Derivatives Arbitrage Funds**

They are open-ended equity schemes aimed to generate low volatility and better returns by investing in a mix of cash equities, equity derivatives and
debt markets. This fund provides better returns, tax benefits and greater liquidity. They exploit arbitrage opportunities available between the cash and futures market.

7) Fixed Maturity Plans

They are debt oriented funds, which invest in fixed income securities like bonds, government securities and money market instruments. As these bonds are held to maturity, these funds are relatively less susceptible to interest rate risk. Such funds lock-in the yield till maturity to curb the interest rate risk. They are popular as they provide higher returns in the shorter term.

8) Capital Protection Schemes

Such schemes aim at protecting the initial capital investment of the investor. Under this scheme, a greater percentage of the corpus is invested in highly rated debt securities to ensure capital protection and a small percentage of the corpus is invested in equities to gain from capital appreciation to provide a return higher than the traditional low-return assumed schemes of government and banks.

9) Gold Exchange Traded Funds

Such funds invest primarily in gold and gold related instruments, thus, investors are allowed to participate in the gold bullion market without taking physical delivery of gold. The SEBI permitted introduction of Gold Exchange Traded Fund (GETF) schemes by mutual funds in 2006. In India, investment in gold is a preferred avenue and asset allocation in gold is around 10 percent. Hence GETFs should be aimed at gold investors who can diversify the portfolio risk and enhance their wealth.

10) Specialized Funds

These funds offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc. There are also funds for investments in securities of specified areas, e.g. Japan fund, South Korea fund etc. Such funds are having a limitation of lack of diversification of investment, which may increase the risk of the firm.
11) Dual Funds

These are special type of close-ended fund. It provides a single investment opportunity for two different types of investors. It sells two types of investment stocks viz, income shares and capital shares. Investors who seek current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive capital gains only.

12) Aggressive Growth Funds

These funds are capital gains oriented and thus the thrust area of these funds is ‘capital gains’. These funds are generally invested in speculative stocks. They may also use specialized investment techniques like short term trading, option writing etc. These funds are more volatile in nature.

13) Sectoral Funds

Such funds invest mainly in shares of a specific sector. They concentrate on a particular industry, such as that of technology, telecommunication, FMCG, petroleum etc. Another variety of specific funds is making investments within a particular segment of the market, for example, large-caps, mid-caps or small-caps fund.

2.6. HISTORY OF MUTUAL FUNDS: WORLD SCENARIO

Mutual funds gained public attention during 1980s and 1990s when mutual fund investment touched boom and investors noticed incredible returns. However, the idea for pooling funds for investment purposes was far back. In fact, historians are not unanimous about the origin of investment funds.

Some opined that the concept of mutual fund dates back to the very dawn of commercial history. In the very beginning Egyptians and Phoenicians started selling shares in vessels and caravans to share the risk involved in these transactions. Some opined that the investment company started by King William I in 1822 in Netherlands
was the first mutual fund. In 1822, the king of Belgium formed the first investment company called ‘SocieteGenerale de Belgique’ in order to finance investments in national industries with high associated risks. While others viewed that the credit went to a Dutch merchant named Adriaan van Ketwich who started an investment trust in 1774. They point out that King William got the idea from Ketwich who theorized that diversification would attract investment of savings from small investors. He named his fund as ‘EendragtMaaktMagt’ meaning ‘Unity creates Strength’. Later on, similar agencies were formed in Switzerland, France, Germany and rest of the Europe.

The concept of investment trust gained momentum in Great Britain. The first investment trust ‘The Foreign and Colonial Government Trust’ was established in London in 1868. This was the real pioneer in the field of modern day concept of mutual fund. The ‘Trust’ was established to provide the opportunity to small investors to invest their money in foreign and colonial companies. Later in 1873, the Scottish American Trust was founded by Robert Fleming at Dundee (Gulbert, 1990). In England, the early institutions were created under legal form known as the old English Trust. People who had experience in large trust estates were appointed as trustees and capital was entrusted to them for purchasing securities.

Although in nineteenth century, many British investment trusts invested in American stocks, the first American investment trust was the closed-ended Boston Personal Property Trust created in 1893. This was the first closed-end fund in the US. It was not until the 1920s that the US experienced a boom in closed-end investment trusts. The creation of the Alexander Fund in Philadelphia in 1907 was the first step towards the modern mutual fund. This fund featured semi-annual issues and allowed withdrawals of fund on demand.

The great bull markets of the 1920s and 1980s provided fertile soil for mutual funds. Basically mutual funds in America are the concept of Unit Trust of Britain. In USA, mutual funds have come a long way since March 21, 1924 when the first mutual fund the Massachusetts Investment Trust (MIT) was launched in Boston in 1924. This was the first open ended mutual fund in U.S. Initially, State Street Investor’s Trust was the custodian of the MIT but later on, it started its own fund in 1924 with Richard Paine, Richard Saltonstall and Paul Cabot at the helm. Saltonstall with Scudder, Stevens and
Clark launched the first no load fund in 1928. In the same year the Wellington Fund was launched which was the fund to include stocks and bonds. By 1929, there were 19 open ended and 700 closed end funds indicating a rising trend in the mutual fund industry. After the stock market crash of 1929, these closed-end investment trusts were characterized as the ‘evil trusts’ that manipulated the stock market and had a hand in causing the great crash of 1929. These changes added to the flourish of securities regulation, in the 1930s, which created the Securities and Exchange Commission (SEC). The SEC recommended the passage of legislation, which materialized in 1940. The Investment companies Act of 1940 provides rules and regulations for the establishment and management of mutual funds. In fact, the enactment of Securities Act of 1933, Securities and Exchange Act of 1934, Investment Company Act of 1940 and Investment Advisors Act of 1940, led to the revival of mutual funds in USA.

Post world war II period showed a phenomenal growth in the mutual fund industry throughout the world. By this time mutual fund companies were also developed in Asia, Far East, Latin America and Canada. In Canada, during 1920s many close ended investment companies were set up. These are generally known as investment trusts. The first mutual fund in Canada was the Canadian Investment Fund in 1932. The two other funds organized in 1930 were Commonwealth International Corporation Limited and Corporate Investors Limited. These three funds are now amongst the giants of mutual funds in Canada.

In the mean time, a large number of mutual funds emerged and expanded their wings in many countries in Europe, the Far East and Latin America. In recent years mutual funds in Japan and Far East countries have been performed well as a result of its sound economy and capital market. Countries in pacific area like Hongkong, Thailand, Singapore and Korea have also entered this field in a long way. Mauritius and Netherlands are emerged as tax heavens for off-shore mutual funds. Thus mutual fund culture is now global in scope.

The expansion of mutual fund industry was a continuous phenomenon. The number of open-ended funds stood at 100 at the beginning of 1950s. The situation of 1929 was gradually improving and as a result in 1954, the mutual fund industry began to grow in earnest adding some 50 new funds. During 1960s, significant rise was registered in
respect of aggressive growth funds. More than 100 new funds were established during this period.

The bear market of 1969 caused a cooling off period, but the growth in the industry later resumed. In Australia and New Zealand mutual funds are commonly known as managed funds or unit trusts. Australia has had managed funds since the second world war whereas New Zealand’s Unit Trusts Act of 1960 signified a change of heart by the Capital Issues Committee who until then were blocking attempts to introduce this type of investment. However, the Portfolio Investment Entity (PIE) regime which started on October, 2007 relating to effective taxation rate is an attempt to simplify mutual fund investments in New Zealand.

During 1970s many no-load funds and index funds emerged. In 1971, William Fouse and John McQuown of Wells Fargo Bank established the first index fund. In 1976, John Bogle introduced the Vanguard Group, a mutual fund powerhouse which was popular for low cost index funds. During 1980s, and 1990s, the bull market mania came and, therefore, the previously obscure fund managers become the leaders. Max Haine, Michael Price and Peter Lynch became much popular in pooling retail investment form household investors.

In 1993, the exchange traded funds (ETFs) was introduced by State Advisors and the American Stock Exchange which is a remarkable development in mutual fund industry worldwide. It was started with standard and poor depository receipts popularly known as spiders. diamonds, qubes, webs and vipers were added later. These new comers with strange nicknames have exploded in popularity within a very short time. As on June 2004, investors had poured over $ 178 billion into them.

More recently, the 2003 mutual fund scandals and the global financial crisis of 2008-2009 put the mutual fund industry in hardship. However, in spite of these, the story of mutual fund is far from over. The industry is still growing at a slow rate. In the US alone, there are more than 10,000 mutual funds at present holding trillions of dollars of assets under management.
Table 2.1

World-wide Total Net Assets in USD (Millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Assets</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>11,654,866</td>
<td>------</td>
</tr>
<tr>
<td>2002</td>
<td>11,324,129</td>
<td>-2.84</td>
</tr>
<tr>
<td>2003</td>
<td>14,048,311</td>
<td>24.06</td>
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<tr>
<td>2004</td>
<td>16,164,793</td>
<td>15.07</td>
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<tr>
<td>2005</td>
<td>17,771,366</td>
<td>9.94</td>
</tr>
<tr>
<td>2006</td>
<td>21,808,884</td>
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<td>2007</td>
<td>26,132,316</td>
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<td>CAGR</td>
<td>7.40</td>
<td></td>
</tr>
</tbody>
</table>


It is apparent from Table-2.1 that the total net assets in USD of mutual funds worldwide has increased during the period 2001-2011 except having negative growth rate in 2002 (2.84%), 2008 (27.60%) and 2011 (3.70%)

The above data relates to 46 countries of the world. The Table-2.1 shows that in the year 2001, the total net assets of mutual funds worldwide stood at USD 11,654,866 million, which increased to USD 23,796,672 million in 2011 registering a CAGR of 7.40 percent.
Exhibit 2.2 shows that the net assets of mutual funds worldwide have increased during the period 2001-2011. It was the highest in the year 2007 (26,132,316 million USD). The growth trend was hit by global financial crisis in 2008 and the net assets declined by 27.6 percent but afterwards the situation was improving gradually.

At present mutual funds worldwide offer varied schemes with different investment objectives and options. Exhibit-2.3 shows the composition of worldwide mutual fund assets.
Note: Other/ unclassified includes total funds in Ireland.

Exhibit 2.3 shows that at the end of the first quarter of 2011, 43 percent of worldwide mutual fund assets were held in equity funds, 22 percent in bond fund, 11 percent in balanced/mixed fund, 19 percent in money market and the rest 5 percent in other/ unclassified fund (Source: Investment Company Institute, News, Q1,2011).

Exhibit 2.4 shows that by region 55 percent of worldwide assets were in the Americas in the first quarter of 2011, 32 percent were in Europe and 13 percent were in Africa and the Asia and Pacific region.
Exhibit 2.4

Composition of World Wide Mutual Fund Assets by Region, 2011 Q-1

Source: Investment Company Institute, News, Q1, 2011

The number of mutual funds worldwide has increased rapidly in the 1990s and during the recent years. The mutual fund industry worldwide started its journey in 1924 with one (1) mutual fund (Massachusetts Investor Trust) in Boston. The number of mutual funds increased to 68 in 1940, 53371 in 2001 and 72611 in 2011.
Table 2.2 presents the number of mutual funds existing worldwide during 2001-2011.

Table 2.2

Worldwide Number of Mutual Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Mutual Funds</th>
<th>Increase/Decrease</th>
<th>% Increase/ Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>53,371</td>
<td>-----</td>
<td>-------</td>
</tr>
<tr>
<td>2002</td>
<td>53,996</td>
<td>625</td>
<td>1.17</td>
</tr>
<tr>
<td>2003</td>
<td>54,569</td>
<td>573</td>
<td>1.06</td>
</tr>
<tr>
<td>2004</td>
<td>55524</td>
<td>955</td>
<td>1.75</td>
</tr>
<tr>
<td>2005</td>
<td>56,868</td>
<td>1344</td>
<td>2.42</td>
</tr>
<tr>
<td>2006</td>
<td>61,855</td>
<td>4987</td>
<td>8.77</td>
</tr>
<tr>
<td>2007</td>
<td>66,347</td>
<td>4492</td>
<td>7.26</td>
</tr>
<tr>
<td>2008</td>
<td>68,574</td>
<td>2227</td>
<td>3.36</td>
</tr>
<tr>
<td>2009</td>
<td>67,530</td>
<td>-1044</td>
<td>-1.52</td>
</tr>
<tr>
<td>2010</td>
<td>69,493</td>
<td>1963</td>
<td>2.91</td>
</tr>
<tr>
<td>2011</td>
<td>72,611</td>
<td>3118</td>
<td>4.49</td>
</tr>
<tr>
<td>CAGR</td>
<td>3.13 %</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Compiled from Mutual Fund Fact Book, 2008 & 2012

Table 2.2 and Exhibit 2.5 show that despite of liquidation of some mutual funds in 2009 (1044 funds), the number of mutual funds worldwide increased to 72611 by the end of 2011 (CAGR 3.13%). By type of fund, 40 percent funds were equity funds, 23 percent were balanced/mixed funds, 18 percent were bond fund, 5 percent were money market funds and the rest 14 percent other/ unclassified funds. (Source: Investment Company Institute)
2.7. HISTORY OF MUTUAL FUNDS: INDIAN SCENARIO

The journey of mutual funds in India was started in 1963 with the establishment of Unit Trust of India (UTI) at the initiative of the government of India and Reserve Bank. The then finance minister T.T. Krishnamachari, emphasized on the role of mutual funds in order to mop up resources from small investors. The Central Banking Enquiry Committee and Shroff Committee also recommended for the introduction of investment trust in India and accordingly the government of India established the Unit Trust of India in 1964 through an Act of Parliament, with a view to augment small savings within the country and to channelize these savings to the capital markets.

The UTI introduced the first scheme (www.amfiindia.com)\textsuperscript{10} Unit- 64 in the year 1964. This was the first open-ended equity scheme and gained overwhelming response within a short period of time. Another popular scheme was launched in 1986 named Master Share scheme. The popularity of these two schemes attracted the attention of banks and other financial institutions to enter into the business of mutual funds in the country and gradually different public sector banks and financial
institutions started mutual fund business. Up to 1987, UTI enjoyed monopoly in mutual fund business. During 1986-87, UTI has launched 20 schemes mobilizing funds amounting to Rs.4,56,500crores (www.nishithdesai.com)\(^1\). But in the year 1987, this monopoly was broken. The reason was that the Government of India permitted the public sector bank and insurance companies to launch mutual fund schemes. As a consequence six public sector banks and two insurance companies’ viz. Life Insurance Corporation of India (LICI) and General Insurance Corporation of India (GICI) started mutual fund business in India and this was a remarkable event in the history of mutual fund industry in India.

In the mean time, a large number of schemes were launched by State Bank of India (SBI), Canara Bank, Punjab National Bank (PNB), Indian Bank, Bank of India (BOI), LIC and GIC, Later on, in 1990s, as a part of economic reforms, various measures were introduced for financial sector reforms. Also, it was realized by different sectors of the economy and financial experts that mutual fund business should be opened for private sector entry in order to enhance competition and efficiency for the interest of investors. The Government of India agreed that the private sector should be allowed to set-up mutual funds which were evident in the Budget speech (1991-92) of the then finance Minister Dr. Man Mohan Singh. He stated “for many investors, mutual funds are a more suitable investment vehicle than direct ownership of shares. Therefore, the government has now decided to promote the development of mutual funds by throwing the field open to the private sector and joint sector” (Finance Bill, 1991)\(^2\).

Moreover, considering the Dave Panel Report in 1991, the Government of India issued new guidelines for setting up of mutual funds in various sectors on February 14, 1992. Subsequently, in 1993, the Securities and Exchange Board of India (SEBI) introduced SEBI (Mutual Funds) Regulations, 1993 which paved the way for the entry of private sector in the mutual fund industry. By the end of 1993, the Securities and Exchange Board of India permitted 13 private sector operators to operate the mutual fund activities Kothari Pioneer Mutual fund was the first fund established in the private sector in July 1993. Since then, the mutual fund industry has grown tremendously and it has become a very important and dynamic sector in India’s capital market at present.
The history of mutual funds in India can be broadly divided into the following five distinct phases:

**Phase I (1964-1987): Establishment and Growth of UTI**

The formation of Unit Trust of India marked the evolution of the Indian mutual fund industry in the year 1963. It was set up and controlled by the Reserve Bank of India up to 1978. After 1978, the Industrial Development Bank of India took over the regulatory and administrative control of UTI. UTI launched its first scheme in 1964, named as Unit Scheme 1964 (US-64) and later on many other schemes which attracted large number of investors. The most important schemes include ULIP in 1971, Children’s Gift fund and India Fund in 1986, Master Share in 1987. At the end
Phase II (1987-1993): Entry of Public Sector Funds

In 1987, a number of public sector banks and financial institutions entered into the mutual fund industry. The first non-UTI mutual fund was started by the State Bank of India in November 1987 followed by Can Bank Mutual fund (December 1987), Punjab National Bank (August 1989), Indian Bank (November 1989) Bank of India (June 1990), Bank of Baroda (October 1992), LICI (June 1989), GICI (December 1990). At the end of 1993, the assets under management of mutual fund industry stood at `47004 crores (SEBI Report, 1993). However, UTI remained to be the leader with about 80% market share.


Phase IV (1996-2004): Growth and SEBI Regulation

In the year 1996, the first set of regulations for mutual funds was issued by the Securities and Exchange Board of India resulting which the industry witnessed robust growth in respect of resource mobilization, number of funds and number of schemes. Also the Government offered tax benefits to the investors in order to encourage them. During this phase various investor awareness programmes were introduced by both SEBI and AMFI. Moreover, in 2003, following the repeal of the Unit Trust of India Act, 1963, UTI was bifurcated into two separate entities- the specified undertaking and the UTI mutual fund. The specified undertaking of the UTI representing broadly, the assets of US 64 scheme, was functioning under the rules framed by the Government and not as per SEBI regulation while UTI mutual fund
came under the preview of SEBI regulations. In fact, the mutual fund industry entered its current phase of consolidation and growth during this phase. As a result, the number of mutual funds stood at 29 at the end of September, 2004 and a total of ₹ 5,90,190 crores (SEBI Report, 2007)$^{16}$ was mobilized by the mutual fund industry.

**Phase V (2004 onwards): Growth and Consolidation**

Since 2004, the industry has witnessed several mergers and acquisitions. For example, acquisition of Alliance Mutual Fund by Birla Sun life Mutual Fund, Sun F& C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, many international mutual funds have entered India like Fidelity, Franklin Templeton Mutual Fund etc. At present there are 51 SEBI registered mutual funds in India (SEBI Report, 2011)$^{17}$. So the journey of mutual fund is continuing through consolidation and entry of new international and private sector players.

### 2.8. ORGANIZATION STRUCTURE OF MUTUAL FUNDS

In India a mutual fund is set up in the form of a trust under the Indian Trust Act, 1882. It consists of sponsor, trustees, Asset Management Company (AMC) and a custodian. The trust is established by a sponsor by an agreement with the trustees. The agreement is called Trust Deed which is required to be registered under the Indian Registration Act 1908. A corporate entity, existing debenture trustee, bank, financial institution and Board of Trustees are eligible for trusteeship.
A typical mutual fund structure in India can be graphically represented as follows:

Exhibit 2.7

Organization Structure of Mutual Funds

In India, the Securities and Exchange Board of India regulates the operation of mutual fund business \((SEBI (Mutual Funds) Regulations, 1996)\). Any person / entity proposing to set up mutual fund in India are required to be registered with the SEBI as per SEBI (Mutual Funds) Regulations, 1996.

Source: Compiled from www.nishitdesai.com
Sponsor

The sponsor is just like a promoter of a company. Under the provisions of Mutual fund Regulations, a sponsor is required to have a sound track record, a reputation of fairness and integrity in all his business transactions. Additionally he should contribute at least 40% to the net worth of the AMC.

Trustees

Indian mutual funds should have their independent Board of Trustees. It implies that two-thirds of the trustees should be independent persons who are not associated with the sponsors in any manner whatsoever. An AMC or any of its employees are not eligible to act as a trustee of any mutual fund. If a company is appointed as a trustee, then its directors can act as trustees of any other trust subject to difference in the objectives of such other trust and the mutual fund.

As per the Trust Deed, the trustees shall discharge the following duties and responsibilities (Singh & Singh, 2001)\(^{19}\):

- To ensure that the AMC has all its system in place, all key personnel, auditors, registrars etc. have been appointed prior to the launch of any scheme.
- To ensure that the AMC does not act in a manner that is favorable to its associates such that it has a detrimental impact on the unit holders or that the management of one scheme does not compromise the management of another scheme.
- To ensure that an AMC has been diligent in empanelling and monitoring any securities transactions with brokers so as to avoid any under concentration of business with any broker.
- To prevent any conflict of interest between the AMC and the unit holders in terms of deployment of net worth.
- To act in the best interest of the unit holders and shall provide information to the unit holders and SEBI as may be specified by SEBI.
- To ensure that the funds under the various schemes floated and managed by the AMC are in accordance with the trust deed and the guidelines issued by SEBI.
2.9. ASSET MANAGEMENT COMPANY (AMC)

An Asset Management Company is required to be appointed by the sponsor or the trustees of a mutual fund. An AMC is an entity registered under the Companies Act, 1956 to manage the money invested in the mutual fund and to operate the schemes of the mutual fund as per regulations. Professional money managers are appointed by the asset management company to take care that the investors corpus are invested in profitable securities based on the risk appetite of the investors and according to the mutual fund schemes. The minimum net worth of an AMC is ₹10 crore, of which not less than 40% is to be contributed by the sponsor.

Custodian

A custodian is a person who has been granted a certificate of Registration to conduct the business of custodial services under the SEBI (Custodian of Securities) Regulations, 1996. Custodial services include maintenance of accounts of clients’ securities together with the collection of benefits/rights accruing to a client. Custodians are required because of the fact that AMC can concentrate on areas such as investment and management of money.

In short, a mutual fund is a set up in the form of a trust, which has sponsor, trustees, asset management company (AMC) and a custodian. The trust is established by a sponsor who is like a promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit-holders. The AMC, approved by the SEBI, manages the funds by making investments in various types of securities. The custodian holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. (www.nishithdesai.com).
References:

8. Sec. 2 (m), *SEBI (Mutual Funds) Regulations*, 1993.
10. [www.amfiindia.com](http://www.amfiindia.com)
11. [www.nishith desai.com](http://www.nishith desai.com)