CHAPTER: 1
Overview of Mutual Funds in India

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CHAPTER: 1
Overview of Mutual Funds in India

After the government policy of liberalization in the industrial and financial sector, many new financial instruments came into existence. Among these mutual fund products have proved to be the most catalytic instrument in the Indian capital market. Mutual Fund is designed to target small investors, salaried people and others who are intimidated by the mysteries of stock market but, nevertheless like to reap the benefits of stock market investing. The growing importance and interest of investors towards Indian mutual fund may be noted, in terms of increased mobilization of funds and the increasing number of schemes and investors in the industry. To fulfill the expectations of millions of account holders, the mutual fund are required to function as successful institutional investors. There is a substantial growth in mutual fund market is due to a high level of precision in the design and marketing of variety of mutual fund products.

Researchers have attempted to study the changing perception of investors towards mutual fund investments, their needs and expectations from different type of mutual funds available in Indian market and identify the risk return perception with the purchase of mutual fund. Various techniques applied to find the important characteristics being considered by the Indian investors in investment decision. Today investors are on the way of exploring the mutual fund investment and willing to know how best it can serve as an investment tool.

Indian financial market presents multiple avenues to the investors. Though certainly not the best or the deepest of markets it has ignited the growth rate in mutual fund industry to provide reasonable options for an ordinary person to invest their savings. With the progressive liberalization of economic policies, there has been a rapid growth of captive markets and financial services industry including merchant banking, leasing and venture
capital. Consistent with this evolution of the financial sector, the mutual fund industry has also come to occupy an important role.

1.1 CONCEPT AND MEANING OF MUTUAL FUND

Mutual fund is a trust that pools money from a group of investors (sharing common financial goals) and invest the money thus collected into asset classes that match the stated investment objectives of the scheme. Since the stated investment objective of a mutual fund scheme generally forms the basis for an investor's decision to contribute money to the pool, a mutual fund can not deviate from its stated objectives at any point of time.

Every Mutual Fund is managed by a fund manager, who using his investment management skills and necessary research works ensures much better return than what an investor can manage on his own. The capital appreciation and other incomes earned from these investments are passed on to the investors (also known as unit holders) in proportion of the number of units they own.
When an investor subscribes for the units of a mutual fund, he becomes part owner of the assets of the fund in the same proportion as his contribution amount put up with the corpus (the total amount of the fund). Mutual Fund investor is also known as a mutual fund shareholder or a unit holder.

Any change in the value of the investments made into capital market instruments (such as shares, debentures etc.) is reflected in the Net Asset Value (NAV) of the scheme. NAV is defined as the market value of the Mutual Fund scheme's assets net of its liabilities. NAV of a scheme is calculated by dividing the market value of scheme's assets by the total number of units issued to investors.

For example:

A. If the market value of the assets of a fund is ₹ 100,000
B. The total number of units issued to the investors is equal to 10,000.
C. Then the NAV of this scheme = (A)/(B), i.e. 100,000/10,000 or 10.00
D. Now if an investor 'X' owns 5 units of this scheme
E. Then his total contribution to the fund is ₹50 (i.e. Number of units held multiplied by the NAV of the scheme)

A **mutual fund** is a professionally-managed type of collective investment scheme that pools money from many investors to buy securities (stocks, bonds, short-term money market instruments, and/or other securities). A mutual fund has a fund manager that trades (buys and sells) the fund's investments in accordance with the fund's investment objective. ¹

**The Security and Exchange Board of India (Mutual Funds) Regulations, 1996** defines a mutual fund as a "a fund establishment 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."

A **mutual fund** is nothing more than a coming together of a group of investors who contribute different sums of money to make up a large lump sum. The money collected is invested by the fund manager in stocks, bonds and other securities - across companies, industries and sectors and in some cases, across countries as well. As an investor, you are issued units in proportion to the money invested. Since you own units of the fund, it makes you less reliant on the success or failure of any individual stock, which would have been the case if you had invested directly in the shares of a single company. ²

“A **mutual fund** is a managed group of possessed securities of several corporations. These corporations receive dividends on the shares that they hold and realize capital gains or losses on their securities traded. Investors purchase shares in mutual funds as if it was an individual security. After paying operating costs, the earnings (dividends, capital gains or losses) of the mutual fund are distributed to the investors, in proportion to the amount of money invested.”

² [www.financialsolutions.in/mutual-funds/](http://www.financialsolutions.in/mutual-funds/)
According to Joseph Checkler mutual fund can be defined in various ways as follows:

1. “Something that is shared mutually.”
2. “A portfolio of stocks that is managed by professionals. The companies are usually related like tech companies are socially responsible companies.”
3. “Mutual fund is somehow related to stocks market and it is a way to build up portfolio through investment.”
4. “It is like a stock portfolio. If someone buys one share in mutual fund, the person is actually buying bunch of different stocks.”

Another saying “Mutual fund is low risk way to invest your money if you are not an expert or do not want to be an expert.”

Mutual funds have an added advantage over other investment options namely:

- **Professional Management:** You avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.

- **Diversification:** Mutual Funds invest in a number of companies across a broad cross-section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.

- **Convenient Administration:** Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

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3 Ibid 1to4 Joseph Checkler (2003)
• **Return Potential:** Over a medium to long term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

• **Low Cost:** Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

• **Liquidity:** In open-ended schemes, you can get your money back promptly at Net Asset Value (NAV) related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price or avail of the facility of repurchase through Mutual Funds at NAV related prices which some close-ended and interval schemes offer you periodically.

• **Transparency:** You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager’s investment strategy and outlook.

• **Flexibility:** Through features such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP) and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

• **Choice of Schemes:** Mutual Funds offer a variety of schemes to suit your varying needs over a lifetime.

• **Well Regulated:** All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

• **Tax Benefits:** Specific schemes of mutual funds (*Equity Linked Savings Schemes*) give investors the benefit of deduction of the amount invested, from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability.
1.1.1 Role of Mutual Fund

Mutual funds perform different roles for different constituencies:

Their primary role is to assist investors in earning an income or building their wealth, by participating in the opportunities available in various securities and markets.

It is possible for mutual funds to structure a scheme for any kind of investment objective. Thus, the mutual fund structure, through its various schemes, makes it possible to tap a large corpus of money from diverse investors. (Therefore, the mutual fund offers schemes. In the industry, the words ‘fund’ and ‘scheme’ are used interchangeably. Various categories of schemes are called “funds”. However, wherever a difference is required to be drawn, the scheme offering entity is referred to as “mutual fund” or “the fund”)

The money that is raised from investors, ultimately benefits governments, companies or other entities, directly or indirectly, to raise moneys to invest in various projects or pay for various expenses.

As a large investor, the mutual funds can keep a check on the operations of the investee company, and their corporate governance and ethical standards.

The projects that are facilitated through such financing, offer employment to people; the income they earn helps the employees buy goods and services offered by other companies, thus supporting projects of these goods and services companies. Thus, overall economic development is promoted.

The mutual fund industry itself, offers livelihood to a large number of employees of mutual funds, distributors, registrars and various other service providers.

Higher employment, income and output in the economy boost the revenue collection of the government through taxes and other means. When these are spent prudently, it promotes further economic development and nation building.

Mutual funds are therefore viewed as a key participant in the capital market of any economy.
1.1.2 Organization and working of mutual fund

There are many entities involved in the organizational set up of Mutual Fund:

- The sponsor(s), The Board of Trustees (BOT) or Trust Company.
- Asset Management Company (AMC - conducts necessary research and based on it, manages the fund or portfolio, and it is also responsible for floating, managing, redeeming the schemes).
- The Custodian (responsible for coordinating with brokers, the actual transfer and storage of stocks and handling the property of the trust), and
- The Unit Holders.

The diagram below illustrates the organizational setup of Mutual Fund:

Organization of Mutual Fund

To protect the interest of the investors, SEBI formulates policies and regulates the mutual funds. It notified regulations in 1993 (fully revised in 1996) and issues guidelines from time to time. MF either promoted by public or by private sector entities including one promoted by foreign entities is governed by these Regulations.

SEBI approved Asset Management Company (AMC) manages the funds by making investments in various types of securities. Custodian, registered with SEBI, holds the securities of various schemes of the fund in its custody.
According to SEBI Regulations, two thirds of the directors of Trustee Company or board of trustees must be independent.

The Association of Mutual Funds in India (AMFI) reassures the investors in units of mutual funds that the mutual funds function within the strict regulatory framework. Its objective is to increase public awareness of the mutual fund industry. AMFI also is engaged in upgrading professional standards and in promoting best industry practices in diverse areas such as valuation, disclosure, transparency etc.

Figure 1.1 Working of Mutual Fund

Mutual fund schemes announce their investment objective and seek investments from the public. Depending on how the scheme is structured, it may be open to accept money from investors, either during a limited period only, or at any time.

The investment that an investor makes in a scheme is translated into a certain number of ‘Units’ in the scheme. Thus, an investor in a scheme is issued units of the scheme. Under the law, every unit has a face value of Rs10. (However, older schemes in the market may have a different face value). The face value is relevant from an accounting perspective. The number of units multiplied by its face value (Rs10) is the capital of the scheme – its Unit Capital.
The scheme earns interest income or dividend income on the investments it holds. Further, when it purchases and sells investments, it earns capital gains or incurs capital losses. These are called realized capital gains or realized capital losses as the case may be. Investments owned by the scheme may be quoted in the market at higher than the cost paid. Such gains in values on securities held are called valuation gains. Similarly, there can be valuation losses when securities are quoted in the market at a price below the cost at which the scheme acquired them.

Investments can be said to have been handled profitably, if the following profitability metric is positive:

(A) Interest income
(B) + Dividend income
(C) + Realized capital gains
(D) + Valuation gains
(E) – Realized capital losses
(F) – Valuation losses
(G) – Scheme expenses

When the investment activity is profitable, the true worth of a unit goes up; when there are losses, the true worth of a unit goes down. The true worth of a unit of the scheme is otherwise called Net Asset Value (NAV) of the scheme.

When a scheme is first made available for investment, it is called a ‘New Fund Offer’ (NFO). During the NFO, investors may have the chance of buying the units at their face value. Post- NFO, when they buy into a scheme, they need to pay a price that is linked to its NAV.

The money mobilized from investors is invested by the scheme as per the investment objective committed. Profits or losses, as the case might be, belong to the investors. The investor does not however bear a loss higher than the amount invested by him.

Various investors subscribing to an investment objective might have different expectations on how the profits are to be handled. Some may like it to be paid off regularly as dividends. Others might like the money to grow in the scheme. Mutual funds...
address such differential expectations between investors within a scheme, by offering various options, such as dividend payout option, dividend re-investment option and growth option.

An investor buying into a scheme gets to select the preferred option also. The relative size of mutual fund companies is assessed by their assets under management (AUM). When a scheme is first launched, assets under management would be the amount mobilized from investors. Hereafter, if the scheme has a positive profitability metric, its AUM goes up; a negative profitability metric will pull it down. Further, if the scheme is open to receiving money from investors even post-NFO, then such contributions from investors boost the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back the units of investors, the AUM falls.

The AUM thus captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.

1.1.3 Frequently used terms

- **Net Asset Value (NAV)**: Net Asset Value is the market value of the assets of the scheme minus its liabilities. The per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the Valuation Date.

- **Sale Price**: Is the price you pay when you invest in a scheme. Also called Offer Price. It may include a sales load.

- **Repurchase Price**: Is the price at which units under open-ended schemes are repurchased by the Mutual Fund. Such prices are NAV related.

- **Redemption Price**: Is the price at which close-ended schemes redeem their units on maturity. Such prices are NAV related.

- **Sales Load**: Is a charge collected by a scheme when it sells the units. Also called, ‘Front-end’ load. Schemes that do not charge a load are called ‘No Load’ schemes.
• **Repurchase or ‘Back-end’ Load**: Is a charge collected by a scheme when it buys back the units from the unit holders.

1.1.4 **Valuation of Units**

Total market value of the asset / securities in the portfolio of the fund – All liabilities

• \[ \text{NAV} = \frac{\text{Number of fund’s unit outstanding}}{\text{(Market Value of assets – Liabilities) + (Brokerage charges, Commission, Taxes, Stamp duty, other management and administrative expenses)}} \]

• \[ \text{Sales Price} = \frac{\text{Number of Fund’s unit outstanding}}{\text{(Market Value of assets – Liabilities) - (Brokerage charges, Commission, Taxes, Stamp duty, other management and administrative expenses)}} \]

• \[ \text{Repurchase Price} = \frac{\text{Number of Fund’s unit outstanding}}{(\text{NAV}_t - \text{NAV}_{t-1}) + \text{Dividends + Capital Gains}} \]

• \[ \text{Rate of Return} = \frac{\text{NAV}_{t-1}}{\text{NAV}_t} \]

Where:

- \( \text{NAV} \) = Net asset value
- \( t \) = Current year
- \( t-1 \) = Previous year
1.2 ORIGIN OF MUTUAL FUNDS

1.2.1 Global View:

History of Mutual Funds has evolved over the years and it is sure to appear as something very interesting for all the investors of the world. In present world, mutual funds have become a main form of investment because of its diversified and liquid features. Not only in the developed world, but in the developing countries also different types of mutual funds are gaining popularity very fast in a tremendous way. But, there was a time when the concepts of Mutual Funds were not present in the economy.

The modern mutual fund was first introduced in Belgium in 1822. This form of investment soon spread to Great Britain and France. Mutual funds became popular in the United States in the 1920s and continue to be popular since the 1930s, especially open-end mutual funds. Mutual funds experienced a period of tremendous growth after World War II, especially in the 1980s and 1990s.

In the Beginning

Historians are uncertain of the origins of investment funds; some cite the closed-end investment companies launched in the Netherlands in 1822 by King William I as the first mutual funds, while others point to a Dutch merchant named Adriaan van Ketwich whose investment trust created in 1774 may have given the king the idea. Ketwich probably theorized that diversification would increase the appeal of investments to smaller investors with minimal capital. The name of Ketwich’s fund, *Eendragt Maakt Magt*, translates to "unity creates strength". The next wave of near-mutual funds included an investment trust launched in Switzerland in 1849, followed by similar vehicles created in Scotland in the 1880s.

The idea of pooling resources and spreading risk using closed-end investments soon took root in Great Britain and France, making its way to the United States in the 1890s. The Boston Personal Property Trust, formed in 1893, was the first closed-end fund in the U.S. The creation of the Alexander Fund in Philadelphia in 1907 was an important step in the
evolution toward what we know as the modern mutual fund. The Alexander Fund featured semi-annual issues and allowed investors to make withdrawals on demand.

The Arrival of the Modern Fund

The creation of the Massachusetts Investors' Trust in Boston, Massachusetts, heralded the arrival of the modern mutual fund in 1924. The fund went public in 1928, eventually spawning the mutual fund firm known today as MFS Investment Management. State Street Investors' Trust was the custodian of the Massachusetts Investors' Trust. Later, State Street Investors started its own fund in 1924 with Richard Paine, Richard Saltonstall and Paul Cabot at the helm. Saltonstall was also affiliated with Scudder, Stevens and Clark, an outfit that would launch the first no-load fund in 1928. A momentous year in the history of the mutual fund, 1928 also saw the launch of the Wellington Fund, which was the first mutual fund to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.

Regulation and Expansion

By 1929, there were 19 open-ended mutual funds competing with nearly 700 closed-end funds. With the stock market crash of 1929, the dynamic began to change as highly-leveraged closed-end funds were wiped out and small open-end funds managed to survive. Government regulators also began to take notice of the fledgling mutual fund industry. The creation of the Securities and Exchange Commission (SEC), the passage of the Securities Act of 1933 and the enactment of the Securities Exchange Act of 1934 put in place safeguards to protect investors: mutual funds were required to register with the SEC and to provide disclosure in the form of a prospectus. The Investment Company Act of 1940 put in place additional regulations that required more disclosures and sought to minimize conflicts of interest.

The mutual fund industry continued to expand. At the beginning of the 1950s, the number of open-end funds topped 100. In 1954, the financial markets overcame their 1929 peak, and the mutual fund industry began to grow in earnest, adding some 50 new funds over
the course of the decade. The 1960s saw the rise of aggressive growth funds, with more than 100 new funds established and billions of dollars in new asset inflows. Hundreds of new funds were launched throughout the 1960s until the bear market of 1969 cooled the public appetite for mutual funds. Money flowed out of mutual funds as quickly as investors could redeem their shares, but the industry's growth later resumed.

**Recent Developments**

In 1971, William Fouse and John McQuown of Wells Fargo Bank established the first index fund, a concept that John Bogle would use as a foundation on which to build The Vanguard Group, a mutual fund powerhouse renowned for low-cost index funds. The 1970s also saw the rise of the no-load fund. This new way of doing business had an enormous impact on the way mutual funds were sold and would make a major contribution to the industry's success. With the 1980s and '90s came bull market mania and previously obscure fund managers became superstars; Max Heine, Michael Price and Peter Lynch, the mutual fund industry's top gunslingers, became household names and money poured into the retail investment industry at a stunning pace. More recently, the burst of the tech bubble and a spate of scandals involving big names in the industry took much of the shine off of the industry's reputation. Shady dealings at major fund companies demonstrated that mutual funds aren't always benign investments managed by folks who have their shareholders' best interests in mind.

As per Rene’M. Stulz (2007) study, in the United States, investment advisors with less than 15 clients do not have to register with the Securities and Exchange Commission under the Investment Advisers Act 1940. The Securities and Exchange Commission wanted to force registration of hedge fund managers because hedge fund collapses had generated large losses for their investors, arguably indicating a need for greater investor protection. The SEC brought 51 hedge fund fraud cases from 2000 to 04. The US Securities and Exchange Commission (2003) estimate the damages in these cases to amount to $1.1 billion.
With renewed confidence in the stock market, mutual fund began to blossom. A key factor in mutual fund growth in U.S.A. was the 1975 change in the Internal Revenue code allowing individuals to open individual retirement accounts (IRAs).

Mutual Fund can invest in many kind of securities. The most common are cash instruments; stock and bonds, but there are hundreds of sub-categories. Stock funds, for instance, can invest primarily in the shares of a particular industry, such as technology or utilities. These are known as sector funds. Bond funds vary according to risk (eg. high-yield junk bonds or investment-grade corporate bonds), type of issuers (eg. Government agencies, corporations or municipalities), or maturity of the bonds (short- or long-term).

Mutual Funds are the subject to special set of regulatory, accounting and tax rules. In the US, most other types of business entities, they are not taxed on their income as long as they distribute 90 percent of it to their shareholder and the funds meet certain diversification requirements in the Internal Revenue Code. Also, the type of income they earn is often unchanged as it passes through to the shareholders. Mutual fund distributions of tax-free municipal bond income are tax-free to the shareholders. Taxable distributions can be either ordinary income or capital gains, depending on how the fund earned those distributions. Net losses are not distributed or passed through to fund investor. By 1929, in U.S.A., there were 19 open-end mutual funds competing with nearly 700 close-end funds. With the stock market crash of 1929, the dynamic began to change as highly-leveraged close-end funds were wiped out and small open-end funds managed to survive.

Government regulators also began to take notice of the fledging mutual fund industry. The creation of the Securities and Exchange Commission (SEC), the passage of the Securities Act of 1933 and the enactment of the Securities Exchange Act of 1934 put in place safeguards to protect investors: mutual funds were required to register with the SEC and to provide disclosure in the form of a prospectus. The Investment Company Act of 1940 put in place additional regulations that required more disclosures and sought to minimize conflicts of interest. The mutual fund industry continued to expand. At the
beginning of the 1950’s, the number of open-end funds topped 100. In 1954, the financial markets overcame their 1929 plank, and the mutual fund industry began to grow in earnest, adding some 50 new funds over the course of decade. The 1960s saw the rise of aggressive growth funds, with more than 100 new funds established and billions of dollars in new assets inflows.

Hundreds of new funds were launched throughout the 1960s until the bear market of 1969 cooled the public appetite for mutual funds. Money flowed out of mutual fund as quickly as investors could redeem their shares, but the industry’s growth later resumed. In 1971, William Fouse and John McQuown of Wells Fargo Bank established the first index fund, a concept that John Bogle would use as a foundation on which to build The Vanguard Group, a mutual fund powerhouse renowned for low-cost index funds. The 1970s also saw the rise of the no-load fund. This new way of doing business had an enormous impact on the way mutual funds were sold and would make a major contribution to the industry’s success. The mutual funds have grown over the years.

With 1980s and 90s came bull market mania and previously obscure fund managers became superstars; Max Heine, Michael Price and Peter Lynch, the mutual fund industry’s top gunslingers, became household names and money poured into the retail investment industry at a stunning pace. The burst of the tech bubble and a spate of scandals involving big names in the industry took much of the shine off the industry’s reputation. Shady dealings at major fund companies demonstrated that mutual funds aren’t always benign investments managed by the folks who have their shareholder’s best interest in mind and who treat all investor equally. Mutual fund’s really captured the public’s attention in the 1980s and 90s when mutual fund investment hit record highs and investors saw incredible returns. However, has been around for a long time. Here we look at evolution of this investment vehicle, from its beginnings in the Netherlands in the eighteen century to its present status as a growing, international industry with fund holdings accounting for trillions of dollars in the united states alone and millions of trillions of dollars in the world in general.
The global investment capability of US mutual fund and pension funds dwarfs that of any other country (Investment Company Institute, 2005). The USA had 8,029 mutual funds out of a global total of 66,350 funds operating at the end of 2007. The relative size of these funds again dwarfs those of other countries, with the US funds having worldwide total net assets of $120,210,27 million out of a global total of $261,994,9 million. The 8,029 long-term US mutual funds are, of course not independently managed. It is estimated that the top “fund families” control most of these assets. The industry is a concentrated one with the top few fund families accounting for majority of total industry assets. This level of concentration has been remarkably stable over the last 20 years—even though the number of mutual fund has climbed from 3,079 in 1990 to 8,029 in 2007 and total net assets have climbed from $1.065 trillion in 1990 to $120,210,27 million in 2007.

Since 1940, there have been three basic types of investment companies in the United States: open-end funds, as known in US as mutual fund; unit investment trusts (UITs); and close-end funds. Similar funds also operate in Canada. However, in the rest of the world mutual fund is used as a generic term for various types of collective investment vehicles, such as unit trusts, open-ended investment companies (OEICs).

According to Strauss (2005), the top 10 fund families in the USA control 35.5 percent of total assets while the top 25 fund families control 45.9 percent of total assets. According to the Investment Company Institute (2005) worldwide the top ten control and manage over 51 percent of total mutual fund net assets and the top 25 control 74 percent. Whatever, the reality, the fund families can be assumed to hold considerable sway over the direction, conditions for and actual final allocation of assets worldwide.

In mutual fund market, fund performance agency rating also exists. In addition to the agencies rating credit, there are the information and investment advisory rate mutual funds. Among these are Morningstar, Standard and Poor’s and Lipper in USA. Morning star introduced its current fund rating system. Morning segregates fund into 48 categories, such as large growth, small value, specialty financial, and the like, depending on their holdings.
It compares each fund only to other funds in the same category, rather than to the entire market. Morningstar computes a score for each fund by comparing its return, after adjusting for loads and other sales charges, to its risk rating. The top 10 percent of funds in each category, based on the return to risk ratio, receive five stars, and the lowest 10 percent receive one star. Morningstar now rates over 2,000 mutual funds on the basis of their relative performance. Standard and Poor’s mutual fund ratings are AAA, AA or A. Less than 20 percent of funds achieve an S & P Fund Management Rating, graded AAA (highest quality), AA (very high), and A (high) and are based on the fund industry’s most extensive set of performance benchmarks. Several of its 160 indices for the open-end, close-end and variable annuity universes track performance since the early 1960s. Today, Lipper’s index service is probably the world’s best known- notable not only for its breadth and depth but also for its unique creations, such as Lipper 1,000 Index, which focuses on the 1,000 largest open-end funds. The significant expansion of the mutual fund industry in India, both in terms of the number of funds and schemes and participation of various financial institutions as intermediaries is one of the noticeable trends in the financial sector. This coupled with the surging capital markets and promised returns by the providers of these funds has made it very difficult for the retail investor to choose the fund that would cater to his specific requirements. In such a scenario, a credible and near accurate mutual fund rating becomes all the more crucial.

Mutual fund ratings and rankings highlight fund manager’s performance. These ratings and rankings are increasing in scope and application. The term “fund-family” or “family of funds” refer to a single mutual fund company that offers many mutual funds for various investment objectives. The group of mutual fund is marketed and/or managed under a common brand name of by a single management company. Examples include Dreyfus, Kemper, Fidelity, and T. Rowe Price etc.
Common Traits of All Mutual Funds

Before we can delve into the differences, it important to first describes some basic mutual fund truths. All mutual funds pool the many smaller deposits of individual investors so they can make large purchases in stocks or bonds. Most mutual funds are available to both the retail clients (individual investors) and institutional clients (large companies, foundations, etc.). There is usually a wide selection of funds, both by company and style in each country including a good variety of stock, bond, money market and balanced funds (blends of stocks and bonds in the same fund).

Another commonality among mutual funds throughout the world is that every major economy has specific rules pertaining to the registration, marketing and sale of funds. The mutual fund industry is a highly regulated space, but those regulations differ by country or region. These regulations are in place to protect the consumer. This helps to ensure that the asset manager is keeping the interests of the investor above their own and that the investor does not get taken advantage of. It is very important that the investor feels confident that the proper authority is monitoring the industry as a whole so they will entrust their savings in a mutual fund. If investors lacked confidence, the industry would likely falter.

Differences around the Globe

The mutual funds that are available for investment differ depending on where the investor is domiciled. Let's look at some of the regulators and the regulations to see how the rules shape the funds.

The U.S. Market

All mutual funds marketed to U.S. retail investors must be registered with the SEC and must abide by the rules set forth under the Investment Company Act of 1940, commonly referred to as the "'40s Act". Some of the rules under the '40s Act deal with
diversification issues. Specifically, section 12 limits the amount of fund assets that can be invested in other investment companies. In other words, the rule prohibits a mutual fund from concentrating too many of its holdings in the stock of an investment company, such as a publicly traded broker.

Another rule, 35d-1, commonly referred to as the "name test", makes sure that most (80%) of the mutual fund's holdings are reflective of the fund's name and prospectus. So, if a fund calls itself an "International Equity Fund", 80% of its holdings should be equities, and they need to be international equities. For rules lovers or punishment gluttons, the full text of the '40s Act can be found on The University of Cincinnati's Securities Lawyer's Desk book.

**The European Union**

Mutual funds authorized for sale in Europe are governed by regulations from the Undertakings for Collective Investment in Transferable Securities (UCITS). The most recent iteration of the rules is UCITS III, which differs from the previous rules by paying more attention to the risk monitoring of derivative positions. The rules cover many areas, but like the '40s Act some deal with making sure the fund does not concentrate its holdings to ensure diversification.

To market your fund across all member countries of the European Union, you need only register your fund in one EU country under the authority of that country's financial regulator. For example, in Ireland it is the Irish Financial Services Regulatory Authority (IFSRA). In turn, the IFSRA is part of the Committee of European Securities Regulators, which is in charge of coordinating the securities regulators of all the EU countries.

**The Hong Kong Market**

Hong Kong's rules are the most restrictive. There are two fund governing bodies in the Hong Kong market: the Securities and Futures Commission (SFC) and the Mandatory
Provident Funds Authority (MPFA). The SFC's rules are broader and not as specific or restrictive as the rules set forth by the MPFA. They apply to all funds marketed in Hong Kong, no matter what type of mutual fund they are. In contrast, MPFA only governs funds that are marketed for use in the retirement accounts of its residents. This means that funds suitable for investment in retirement accounts have two regulatory bodies to worry about - they must abide by both the SFC and MPFA rules. However, as the MPFA rules are more restrictive than the SFC rules, fund managers can usually concentrate on the MPFA rules, knowing that compliance with these rules will usually ensure compliance with the broader rules as well.

The MPFA's rules are more restrictive partly because the authority wants to make sure that the nest eggs of its residents are protected and not invested in funds of a speculative nature. The MPFA takes compliance with their rules very seriously. Some of the more restrictive rules deal with unrated or below-investment grade securities, and unlisted securities. The MPFA requires that bond mutual funds sell bonds that have been downgraded below investment grade, even if they were investment grade at time of purchase. The rules also place emphasis on approved exchanges. The MPFA provides its own list of approved stock exchanges. No more than 10% of a mutual fund's securities may be allocated to contain stocks not listed on one of these approved exchanges.

Other Markets

Markets other than the three mentioned above, have their own structure and regulations. In Canada for example, mutual funds are subject to provincial securities laws as well as national rules known as "NI 81-102". The NI stands for "National Instrument". For example, dealers who sell mutual funds must be registered with the securities regulator of their province, while the mutual fund asset manager must ensure that the fund they manage abides by the NI 81-102 rules.
Another market that is currently opening up to outside fund managers is the Taiwan market. In Taiwan the regulator is the Financial Supervisory Committee (FSC). There are only about 20 rules specific to mutual funds marketed in Taiwan, but this is still an evolving market.

**Importance of Rules**

Understanding the differences among the financial regulators is very important for a mutual fund manager. A manager may have different funds registered amongst these different regulatory environments, and they need to make sure that they understand what they can and cannot do in each of the countries. Breaching a rule especially a major one can give a fund and its manager a bad reputation, a fine, or both.

**Table 1.1: Worldwide Number of Mutual Funds/Schemes**

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**Note:** Data are as of September 2012.

**Source:** Investment Company Institute.
the collective efforts of the Government of South Africa, Turkey, Switzerland, Sweden, Spain, Slovenia, Slovakia, Russia, Romania, Portugal, Poland, Norway, Netherlands, Norway, Nigeria, and the United Kingdom. It was made possible through the collective efforts of the Government of the United Kingdom and the Netherlands.

### Europe-Africa-Middle East

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### Note: Data are as of September 2012.


#### 1.2.2 Indian View

The formation of Unit Trust of India marked the evolution of the Indian mutual fund industry in the year 1963. The primary objective at that time was to attract the small investors and it was made possible through the collective efforts of the Government of
India and the Reserve Bank of India. The history of mutual fund industry in India can be better understood divided into following phases:

**Phase I. Establishment and Growth of Unit Trust of India - 1964-87**

Unit Trust of India enjoyed complete monopoly when it was established in the year 1963 by an act of Parliament. UTI was set up by the Reserve Bank of India and it continued to operate under the regulatory control of the RBI until the two were de-linked in 1978 and the entire control was transferred in the hands of Industrial Development Bank of India (IDBI). UTI launched its first scheme in 1964, named as Unit Scheme 1964 (US-64), which attracted the largest number of investors in any single investment scheme over the years.

UTI launched more innovative schemes in 1970s and 80s to suit the needs of different investors. It launched ULIP in 1971, six more schemes between 1981 and 84, Children's Gift Growth Fund and India Fund (India's first offshore fund) in 1986, Mastershare (India’s first equity diversified scheme) in 1987 and Monthly Income Schemes (offering assured returns) during 1990s. By the end of 1987, UTI's assets under management grew ten times to ₹ 6700 crores.

**Phase II. Entry of Public Sector Funds - 1987-1993**

The Indian mutual fund industry witnessed a number of public sector players entering the market in the year 1987. In November 1987, SBI Mutual Fund from the State Bank of India became the first non-UTI mutual fund in India. SBI Mutual Fund was later followed by Can bank Mutual Fund, LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. By 1993, the assets under management of the industry increased seven times to ₹ 47,004 crores. However, UTI remained to be the leader with about 80% market share.
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**Phase III. Emergence of Private Sector Funds - 1993-96**

The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian promoters) to enter the mutual fund industry in 1993, provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor-servicing technology. By 1994-95, about 11 private sector funds had launched their schemes.

**Phase IV. Growth and SEBI Regulation - 1996-2004**

The mutual fund industry witnessed robust growth and stricter regulation from the SEBI after the year 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds.

Investors’ interests were safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. The Union Budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various Investor Awareness Programmes were launched during this phase, both by SEBI and AMFI, with an objective to educate investors and make them informed about the mutual fund industry.

In February 2003, the UTI Act was repealed and UTI was stripped of its Special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. UTI was re-organized into two parts:
1. The Specified Undertaking,

2. The UTI Mutual Fund

Presently Unit Trust of India operates under the name of UTI Mutual Fund and its past schemes (like US-64, Assured Return Schemes) are being gradually wound up. In 1999, there was a significant growth in mobilization of funds from investors and assets under management which is supported by the following data:

**Table 1.3: Trends in Resource Mobilisation by Mutual Funds (` & crore)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Mobilisation</th>
<th>Redemption</th>
<th>Net Inflow</th>
<th>Assets at The end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private Sector</td>
<td>Public Sector</td>
<td>UTI Total</td>
<td>Private Sector</td>
</tr>
<tr>
<td>2000-01</td>
<td>75,009</td>
<td>5,535</td>
<td>12,413</td>
<td>92,957</td>
</tr>
<tr>
<td>2001-02</td>
<td>1,47,798</td>
<td>12,082</td>
<td>4,643</td>
<td>1.64,523</td>
</tr>
<tr>
<td>2002-03</td>
<td>2,84,096</td>
<td>23,515</td>
<td>7,096</td>
<td>3,14,706</td>
</tr>
<tr>
<td>2003-04</td>
<td>5,34,649</td>
<td>31,548</td>
<td>23,992</td>
<td>5,90,190</td>
</tr>
<tr>
<td>2004-05</td>
<td>7,36,463</td>
<td>56,589</td>
<td>46,656</td>
<td>8,39,708</td>
</tr>
<tr>
<td>2005-06</td>
<td>9,14,703</td>
<td>1,10,319</td>
<td>75,127</td>
<td>10,98,149</td>
</tr>
<tr>
<td>2006-07</td>
<td>15,99,873</td>
<td>1,96,340</td>
<td>1,42,280</td>
<td>19,38,493</td>
</tr>
<tr>
<td>2007-08</td>
<td>37,80,753</td>
<td>3,46,126</td>
<td>3,37,498</td>
<td>44,64,377</td>
</tr>
<tr>
<td>2008-09</td>
<td>42,92,751</td>
<td>7,10,472</td>
<td>4,23,131</td>
<td>54,26,353</td>
</tr>
<tr>
<td>2009-10</td>
<td>76,98,483</td>
<td>8,81,851</td>
<td>14,38,688</td>
<td>1,00,19,023</td>
</tr>
<tr>
<td>2010-11</td>
<td>69,22,924</td>
<td>7,83,858</td>
<td>11,52,733</td>
<td>88,59,515</td>
</tr>
</tbody>
</table>
Phase V. Growth and Consolidation - 2004 Onwards

The industry has also witnessed several mergers and acquisitions recently, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were total 44 AMCs operating in India at the end of December 2012 with AUM ₹7, 59,995 crores. By 2013 there were 49 Mutual Funds registered with SEBI. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players.
Figure 1.2:

GROWTH IN ASSETS UNDER MANAGEMENT

Fig: 1.3 Growth in average assets under management in last five years (in mn INR)

Source: AMFI
The history of the Indian mutual fund industry can be traced to the formation of UTI in 1963. This was a joint initiative of the Government of India and RBI. It held monopoly for nearly 30 years. Since 1987, non-UTI mutual funds entered the scenario. These consisted of LIC, GIC and public-sector bank backed Indian mutual funds. SBI Mutual fund was the first of this kind. 1993 saw the entry of private sector players on the Indian Mutual Funds scene. Mutual fund regulations were revised in 1996 to accommodate changing market needs.

With the Sensex on a scorching bull rally, many investors prefer to trade on stocks themselves. Mutual funds are more balanced since they diversify over a large number of stocks and sectors. In the rally of 2000, it was noticed that mutual funds did better than the stocks mainly due to prudent fund management based on the virtues of diversification.

Some of the major players on the Indian mutual fund scene:

1. Axis Asset Management Company Ltd.
2. Baroda Pioneer Asset Management Company Limited
3. Birla Sun Life Asset Management Company Limited
4. BNP Paribas Asset Management India Private Limited
5. BOI AXA Investment Managers Private Limited
6. Canara Robeco Asset Management Company Limited
7. Daiwa Asset Management (India) Private Limited
8. Deutsche Asset Management (India) Pvt. Ltd.
9. DSP BlackRock Investment Managers Private Limited
10. Edelweiss Asset Management Limited
11. Escorts Asset Management Limited
12. Franklin Templeton Asset Management (India) Private Limited
13. Goldman Sachs Asset Management (India) Private Limited
14. HDFC Asset Management Company Limited
15. HSBC Asset Management (India) Private Ltd.
16. ICICI Prudential Asset Management Company Limited
17. IDBI Asset Management Ltd.
18. IDFC Asset Management Company Limited
19. IL&FS Infra Asset Management Limited
20. India Infoline Asset Management Co. Ltd.
21. Indiabulls Asset Management Company Ltd.
22. ING Investment Management (India) Pvt. Ltd.
23. JM Financial Asset Management Private Limited
24. JPMorgan Asset Management India Pvt. Ltd.
25. Kotak Mahindra Asset Management Company Limited (KMAMCL)
26. L&T Investment Management Limited
27. LIC NOMURA Mutual Fund Asset Management Company Limited
28. Mirae Asset Global Investments (India) Pvt. Ltd.
30. Motilal Oswal Asset Management Company Limited
31. Peerless Funds Management Co. Ltd.
32. Pine Bridge Investments Asset Management Company (India) Pvt. Ltd.
33. PPFAS Asset Management Pvt. Ltd.
Different Indian mutual funds allow investors various solutions ranging from retirement planning and buying a house to planning for child's education or marriage. Tax-wise stocks and mutual funds work similarly since long-term capital gains from both stocks and equity-oriented mutual funds are tax-free.

Well, what are the charges, fees and expenses associated with investing in Indian mutual funds? At the time of entry into a mutual fund, you have to pay an additional charge or entry load along with the value of units purchased. When you exit from the scheme, you will get back the value of the units less the exit load charges. If you want to switch from one type of mutual fund investment to another, you will be required to pay the exchange fees. Advisory fees, broker fees, audit fees and
registrar fees are some of the other recurring expenditures that would be charged to you. These expenses involve administrative and other running costs.

In India, SEBI (The Securities and Exchange Board of India) is the regulating authority that SEBI formulates policies and regulates the mutual funds to protect the interest of the Indian investors. There have been revisions and amendments from time to time. Even mutual funds promoted by foreign entities come under the purview of SEBI when operating in India. SEBI has revised its regulations to allow Indian mutual funds to invest in both gold and gold related instruments.

1.3 TYPES OF MUTUAL FUND SCHEMES

General Classification of Mutual Funds

Open-end Funds | Closed-end Funds

Open-end Funds
Funds that can sell and purchase units at any point in time are classified as Open-end Funds. The fund size (corpus) of an open-end fund is variable (keeps changing) because of continuous selling (to investors) and repurchases (from the investors) by the fund. An open-end fund is not required to keep selling new units to the investors at all times but is required to always repurchase, when an investor wants to sell his units. The NAV of an open-end fund is calculated every day.

Closed-end Funds
Funds that can sell a fixed number of units only during the New Fund Offer (NFO) period are known as Closed-end Funds. The corpus of a Closed-end Fund remains unchanged at all times. After the closure of the offer, buying and redemption of units by the investors directly from the Funds is not allowed. However, to protect the interests of the investors, SEBI provides investors with two avenues to liquidate their positions:

1. Closed-end Funds are listed on the stock exchanges where investors can buy/sell units from/to each other. The trading is generally done at a discount to the NAV of
the scheme. The NAV of a closed-end fund is computed on a weekly basis (updated every Thursday).

2. Closed-end Funds may also offer "buy-back of units" to the unit holders. In this case, the corpus of the Fund and its outstanding units do get changed.

**Load Funds | No-load Funds**

**Load Funds**

Mutual Funds incur various expenses on marketing, distribution, advertising, portfolio churning, fund manager's salary etc. Many funds recover these expenses from the investors in the form of load. These funds are known as Load Funds. A load fund may impose following types of loads on the investors:

1. **Entry Load** - Also known as Front-end load, it refers to the load charged to an investor at the time of his entry into a scheme. Entry load is deducted from the investor's contribution amount to the fund.
2. **Exit Load** - Also known as Back-end load, these charges are imposed on an investor when he/she redeem his/her units (exits from the scheme). Exit load is deducted from the redemption proceeds to an outgoing investor.
3. **Deferred Load** - Deferred load is charged to the scheme over a period of time.
4. **Contingent Deferred Sales Charge (CDSC)** - In some schemes, the percentage of exit load reduces as the investor stays longer with the fund. This type of load is known as Contingent Deferred Sales Charge.

**No-load Funds**

All those funds that do not charge any of the above mentioned loads are known as No-load Funds.

**Tax-exempt Funds | Non-Tax-exempt Funds**

**Tax-exempt Funds**
Funds that invest in securities free from tax are known as Tax-exempt Funds. All open-end equity oriented funds are exempt from distribution tax (tax for distributing income to investors). Long term capital gains and dividend income in the hands of investors are tax-free.

**Non-Tax-exempt Funds**

Funds that invest in taxable securities are known as Non-Tax-exempt Funds. In India, all funds, except open-end equity oriented funds are liable to pay tax on distribution income. Profits arising out of sale of units by an investor within 12 months of purchase are categorized as short-term capital gains, which are taxable. Sale of units of an equity oriented fund is subject to Securities Transaction Tax (STT). STT is deducted from the redemption proceeds to an investor.
1. Equity Funds

Equity funds are considered to be the more risky funds as compared to other fund types, but they also provide higher returns than other funds. It is advisable that an investor looking to invest in an equity fund should invest for long term i.e. for 3 years or more. There are different types of equity funds each falling into different risk bracket. In the order of decreasing risk level, there are following types of equity funds:

a. **Aggressive Growth Funds** - In Aggressive Growth Funds, fund managers aspire for maximum capital appreciation and invest in less researched shares of
speculative nature. Because of these speculative investments Aggressive Growth Funds become more volatile and thus, are prone to higher risk than other equity funds.

b. **Growth Funds** - Growth Funds also invest for capital appreciation (with time horizon of 3 to 5 years) but they are different from Aggressive Growth Funds in the sense that they invest in companies that are expected to outperform the market in the future. Without entirely adopting speculative strategies, Growth Funds invest in those companies that are expected to post above average earnings in the future.

c. **Specialty Funds** - Specialty Funds have stated criteria for investments and their portfolio comprises of only those companies that meet their criteria. Criteria for some specialty funds could be to invest/not to invest in particular regions/companies. Specialty funds are concentrated and thus, are comparatively riskier than diversified funds. There are following types of specialty funds:

i. **Sector Funds**: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are more risky compared to diversified funds.

ii. **Foreign Securities Funds**: Foreign Securities Equity Funds have the option to invest in one or more foreign companies. Foreign securities funds achieve international diversification and hence they are less risky than sector funds. However, foreign securities funds are exposed to foreign exchange rate risk and country risk.

iii. **Mid-Cap or Small-Cap Funds**: Funds that invest in companies having lower market capitalization than large capitalization companies are called Mid-Cap or Small-Cap Funds. Market capitalization of Mid-Cap companies is less than that of big, blue chip companies (less than ₹ 2500 crores but
more than ₨ 500 crores) and Small-Cap companies have market capitalization of less than ₨ 500 crores. Market Capitalization of a company can be calculated by multiplying the market price of the company's share by the total number of its outstanding shares in the market. The shares of Mid-Cap or Small-Cap Companies are not as liquid as of Large-Cap Companies which gives rise to volatility in share prices of these companies and consequently, investment gets risky.

iv. **Option Income Funds**: While not yet available in India, Option Income Funds write options on a large fraction of their portfolio. Proper use of options can help to reduce volatility, which is otherwise considered as a risky instrument. These funds invest in big, high dividend yielding companies, and then sell options against their stock positions, which generate stable income for investors.

d. **Diversified Equity Funds** - Except for a small portion of investment in liquid money market, diversified equity funds invest mainly in equities without any concentration on a particular sector(s). These funds are well diversified and reduce sector-specific or company-specific risk. However, like all other funds diversified equity funds too are exposed to equity market risk. One prominent type of diversified equity fund in India is Equity Linked Savings Schemes (ELSS). As per the mandate, a minimum of 90% of investments by ELSS should be in equities at all times. ELSS investors are eligible to claim deduction from taxable income (up to ₨ 1 lakh) at the time of filing the income tax return. ELSS usually has a lock-in period and in case of any redemption by the investor before the expiry of the lock-in period makes him liable to pay income tax on such income(s) for which he may have received any tax exemption(s) in the past.
e. **Equity Index Funds** - Equity Index Funds have the objective to match the performance of a specific stock market index. The portfolio of these funds comprises of the same companies that form the index and is constituted in the same proportion as the index. Equity index funds that follow broad indices (like S&P CNX Nifty, Sensex) are less risky than equity index funds that follow narrow sectoral indices (like BSE Bank Index or CNX Bank Index etc.). Narrow indices are less diversified and therefore, are more risky.

f. **Value Funds** - Value Funds invest in those companies that have sound fundamentals and whose share prices are currently under-valued. The portfolio of these funds comprises of shares that are trading at a low Price to Earning Ratio (Market Price per Share / Earning per Share) and a low Market to Book Value (Fundamental Value) Ratio. Value Funds may select companies from diversified sectors and are exposed to lower risk level as compared to growth funds or specialty funds. Value stocks are generally from cyclical industries (such as cement, steel, sugar etc.) which make them volatile in the short-term. Therefore, it is advisable to invest in Value funds with a long-term time horizon as risk in the long term, to a large extent, is reduced.

g. **Equity Income or Dividend Yield Funds** - The objective of Equity Income or Dividend Yield Equity Funds is to generate high recurring income and steady capital appreciation for investors by investing in those companies which issue high dividends (such as Power or Utility companies whose share prices fluctuate comparatively lesser than other companies’ share prices). Equity Income or Dividend Yield Equity Funds are generally exposed to the lowest risk level as compared to other equity funds.

2. **Debt / Income Funds**

Funds that invest in medium to long-term debt instruments issued by private companies, banks, financial institutions, governments and other entities belonging to various sectors (like infrastructure companies etc.) are known as Debt / Income Funds. Debt funds are
low risk profile funds that seek to generate fixed current income (and not capital appreciation) to investors. In order to ensure regular income to investors, debt (or income) funds distribute large fraction of their surplus to investors. Although debt securities are generally less risky than equities, they are subject to credit risk (risk of default) by the issuer at the time of interest or principal payment. To minimize the risk of default, debt funds usually invest in securities from issuers who are rated by credit rating agencies and are considered to be of "Investment Grade”. Debt funds that target high returns are more risky. Based on different investment objectives, there can be following types of debt funds:

a. **Diversified Debt Funds** - Debt funds that invest in all securities issued by entities belonging to all sectors of the market are known as diversified debt funds. The best feature of diversified debt funds is that investments are properly diversified into all sectors which results in risk reduction. Any loss incurred, on account of default by a debt issuer, is shared by all investors which further reduces risk for an individual investor.

b. **Focused Debt Funds** - Unlike diversified debt funds, focused debt funds are finely focus funds that are curbed to investments in selective debt securities, issued by companies of a specific sector or industry or origin.

c. **High Yield Debt funds** - As we now understand that risk of default is present in all debt funds, and therefore, debt funds generally try to minimize the risk of default by investing in securities issued by only those borrowers who are considered to be of "investment grade". But, High Yield Debt Funds adopt a different strategy and prefer securities issued by those issuers who are considered to be of "below investment grade". The motive behind adopting this sort of risky strategy is to earn higher interest returns from these issuers. These funds are more volatile and bear higher default risk, although they may earn at times higher returns for investors.
d. **Assured Return Funds** - Although it is not necessary that a fund will meet its objectives or provide assured returns to investors, but there can be funds that come with a lock-in period and offer assurance of annual returns to investors during the lock-in period. Any shortfall in returns is suffered by the sponsors or the Asset Management Companies (AMCs). These funds are generally debt funds and provide investors with a low-risk investment opportunity. However, the security of investments depends upon the net worth of the guarantor (whose name is specified in advance on the offer document). To safeguard the interests of investors, SEBI permits only those funds to offer assured return schemes whose sponsors have adequate net-worth to guarantee returns in the future. In the past, UTI had offered assured return schemes (i.e. Monthly Income Plans of UTI) that assured specified returns to investors in the future. UTI was not able to fulfill its promises and faced large shortfalls in returns. Eventually, government had to intervene and took over UTI's payment obligations on itself. Currently, no AMC in India offers assured return schemes to investors, though possible.

e. **Fixed Term Plan Series** - Fixed Term Plan Series usually are closed-end schemes having short term maturity period (of less than one year) that offer a series of plans and issue units to investors at regular intervals. Unlike closed-end funds, fixed term plans are not listed on the exchanges. Fixed term plan series usually invest in debt / income schemes and target short-term investors. The objective of fixed term plan schemes is to gratify investors by generating some expected returns in a short period.

3. **Gilt Funds**

Also known as Government Securities in India, Gilt Funds invest in government papers (named dated securities) having medium to long term maturity period. Issued by the Government of India, these investments have little credit risk (risk of default) and provide safety of principal to the investors. However, like all debt funds, gilt funds too are exposed to interest rate risk. Interest rates and prices of debt securities are inversely
related and any change in the interest rates results in a change in the NAV of debt/gilt funds in an opposite direction.

4. Money Market / Liquid Funds
Money market / liquid funds invest in short-term (maturing within one year) interest bearing debt instruments. These securities are highly liquid and provide safety of investment, thus making money market / liquid funds the safest investment option when compared with other mutual fund types. However, even money market / liquid funds are exposed to the interest rate risk. The typical investment options for liquid funds include Treasury Bills (issued by governments), Commercial papers (issued by companies) and Certificates of Deposit (issued by banks).

5. Hybrid Funds
As the name suggests, hybrid funds are those funds whose portfolio includes a blend of equities, debts and money market securities. Hybrid funds have an equal proportion of debt and equity in their portfolio. There are following types of hybrid funds in India:

   a. **Balanced Funds** - The portfolio of balanced funds include assets like debt securities, convertible securities, and equity and preference shares held in a relatively equal proportion. The objectives of balanced funds are to reward investors with a regular income, moderate capital appreciation and at the same time minimizing the risk of capital erosion. Balanced funds are appropriate for conservative investors having a long term investment horizon.

   b. **Growth-and-Income Funds** - Funds that combine features of growth funds and income funds are known as Growth-and-Income Funds. These funds invest in companies having potential for capital appreciation and those known for issuing high dividends. The level of risks involved in these funds is lower than growth funds and higher than income funds.
c. **Asset Allocation Funds** - Mutual funds may invest in financial assets like equity, debt, money market or non-financial (physical) assets like real estate, commodities etc.. Asset allocation funds adopt a variable asset allocation strategy that allows fund managers to switch over from one asset class to another at any time depending upon their outlook for specific markets. In other words, fund managers may switch over to equity if they expect equity market to provide good returns and switch over to debt if they expect debt market to provide better returns. It should be noted that switching over from one asset class to another is a decision taken by the fund manager on the basis of his own judgment and understanding of specific markets, and therefore, the success of these funds depends upon the skill of a fund manager in anticipating market trends.

6. **Commodity Funds**

Those funds that focus on investing in different commodities (like metals, food grains, crude oil etc.) or commodity companies or commodity futures contracts are termed as Commodity Funds. A commodity fund that invests in a single commodity or a group of commodities is a specialized commodity fund and a commodity fund that invests in all available commodities is a diversified commodity fund and bears less risk than a specialized commodity fund. "Precious Metals Fund" and Gold Funds (that invest in gold, gold futures or shares of gold mines) are common examples of commodity funds.

7. **Real Estate Funds**

Funds that invest directly in real estate or lend to real estate developers or invest in shares/securitized assets of housing finance companies, are known as Specialized Real Estate Funds. The objective of these funds may be to generate regular income for investors or capital appreciation.
8. Exchange Traded Funds (ETF)
Exchange Traded Funds provide investors with combined benefits of a closed-end and an open-end mutual fund. Exchange Traded Funds follow stock market indices and are traded on stock exchanges like a single stock at index linked prices. The biggest advantage offered by these funds is that they offer diversification, flexibility of holding a single share (tradable at index linked prices) at the same time. Recently introduced in India, these funds are quite popular abroad.

9. Fund of Funds
Mutual funds that do not invest in financial or physical assets, but do invest in other mutual fund schemes offered by different AMCs, are known as Fund of Funds. Fund of Funds maintain a portfolio comprising of units of other mutual fund schemes, just like conventional mutual funds maintain a portfolio comprising of equity/debt/money market instruments or non financial assets. Fund of Funds provide investors with an added advantage of diversifying into different mutual fund schemes with even a small amount of investment, which further helps in diversification of risks. However, the expenses of Fund of Funds are quite high on account of compounding expenses of investments into different mutual fund schemes.

1.4 PROS & CONS OF INVESTING IN MUTUAL FUNDS:
For investments in mutual fund, one must keep in mind about the Pros and cons of investments in mutual fund.

Advantages of Investing Mutual Funds:
The advantages of investing in Mutual Funds are:

1. Professional Management: You avail of the services of experienced and skilled professionals who are backed by a dedicated investment research team which analyses the performance and prospects of companies and selects suitable investments to achieve the objectives of the scheme.
2. **Diversification**: Mutual Funds invest in a number of companies across a broad cross section of industries and sectors. This diversification reduces the risk because seldom do all stocks decline at the same time and in the same proportion. You achieve this diversification through a Mutual Fund with far less money than you can do on your own.

3. **Convenient Administration**: Investing in a Mutual Fund reduces paperwork and helps you avoid many problems such as bad deliveries, delayed payments and unnecessary follow up with brokers and companies. Mutual Funds save your time and make investing easy and convenient.

4. **Return Potential**: Over a medium to long term, Mutual Funds have the potential to provide a higher return as they invest in a diversified basket of selected securities.

5. **Low Costs**: Mutual Funds are a relatively less expensive way to invest compared to directly investing in the capital markets because the benefits of scale in brokerage, custodial and other fees translate into lower costs for investors.

6. **Liquidity**: In open-ended schemes, you can get your money back promptly at Asset Value (NAV) related prices from the Mutual Fund itself. With close-ended schemes, you can sell your units on a stock exchange at the prevailing market price or avail of the facility of repurchase through Mutual Funds at NAV related prices which some close-ended and interval schemes offer you periodically.

7. **Transparency**: You get regular information on the value of your investment in addition to disclosure on the specific investments made by your scheme, the proportion invested in each class of assets and the fund manager’s investment strategy and outlook.

8. **Flexibility**: Through features such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP) and dividend reinvestment plans, you can systematically invest or withdraw funds according to your needs and convenience.

9. **Choice of Schemes**: Mutual Funds offer a variety of schemes to suit your varying needs over a lifetime.
10. **Well Regulated:** All Mutual Funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. The operations of Mutual Funds are regularly monitored by SEBI.

**Disadvantages of Investing in Mutual Funds:**

There are some disadvantages also like:

1. **Professional Management** - Some funds don’t perform in neither the market, as their management is not dynamic enough to explore the available opportunity in the market, thus many investors debate over whether or not the so-called professionals are any better than mutual fund or investor himself, for picking up stocks.

2. **Dilution** - Because funds have small holdings across different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.

3. **Taxes** - when making decisions about your money, fund managers don't consider your personal tax situation. For example, when a fund manager sells a security, a capital-gain tax is triggered, which affects how profitable the individual is from the sale. It might have been more advantageous for the individual to defer the capital gains liability.

**1.5 EMERGENCE OF MUTUAL FUND**

Mutual funds now represent perhaps the most appropriate investment opportunity for most investors; as financial markets become more complicated and sophisticated; investors need a financial intermediary who provides the required knowledge and professional expertise on successful investing. It is no wonder then that in the birth place of mutual fund- the U.S.A. – the fund industry has already overtaken the banking industry, more funds being under mutual fund management than deposited with banks.
The Indian Mutual Fund industry has already started opening up many of the exciting investment opportunities to Indian investors. We have started witnessing the phenomenon of more savings now being entrusted to the funds than to the banks. Despite the continuous growth in the industry, mutual funds are still a new financial intermediary in India. Hence, it is important that the investors, the mutual fund agents/distributors, the investment advisors and even the fund employees acquire better knowledge of what mutual funds are, what they cannot, how the function differently from other intermediaries such as banks.