CHAPTER-1

INTRODUCTION TO THE MUTUAL FUNDS IN INDIA

Contents

1.1 Introduction of the concept
1.2 The concept of Mutual Funds on the Globe
1.3 Origin of the concept of ‘Modern Mutual Funds’
1.4 Important phases of Mutual Funds Industry in India
1.5 Mutual Funds and Tax-benefits
1.6 Resource Mobilization
   1.6.1 Chart-I Growth in Assets Under Management (AUM)
1.7 SEBI and Mutual Funds
   1.7.1 The procedure for registering a Mutual Fund with SEBI
1.8 Association of Mutual Funds in India and Mutual Funds
   1.8.1 The sponsors of Association of Mutual Funds in India
   1.8.2 Chart- II Working of Mutual Funds
1.9 Types of Mutual Funds Schemes in India
   1.9.1 Overview of schemes existing in Mutual Fundscategory
1.10 Advantages of Investing in Mutual Funds
1.11 Disadvantages of Investing in Mutual Funds
1.12 References
1.1 INTRODUCTION OF THE CONCEPT

Mutual-Fund’s concept provides a system through which investors can avail of the facility of entering (Investing) in stock-market according to their own intended motive, and with diversified and managed portfolio. Here investors get a lot of comparative facilities. Through this system one can be entertained with these facilities, first – if they don’t have sufficient knowledge about investing in stock market, still they are able to invest. Second – they can pick the scheme of their own choice, since every investor may be having a separate temperament in investment-behavior, say, regular income requirement, and capital appreciation requirement, no-risk or low risk as their objectives of investment etc. Third we find a large variety of scheme available with it, even in the same category of objective. Fourth, it is diversified to minimize the risk and maximize the returns. Fifth is the expertise of fund management, which is, generally not found in the ordinary investor or the new investor. Sixth, investors can penetrate the stock market with comparatively smaller amount. In mutual fund we usually find ‘economies of scale’ since all investors’ small savings are aggregated and then invested hence, the charges are imposed as a singular identity from the whole corpus not from individual investor, it becomes comparatively cheaper for the investors. The last but not least benefit or origin of this concept is that, it is comparatively safer and regulated environment backed by the regulation of SEBI and AMFI, in India.

Mutual funds are dynamic financial institutions, which play a crucial role in an economy by mobilizing savings and investing them in the capital market. (Singh, 2006, p.4) A mutual fund is an institution that invests the pooled funds of public to create a diversified portfolio of securities. Pooling is the key to mutual fund investing. Each mutual fund has a specific investment objective and tries to meet that objective through active portfolio management. (Gupta, 1989, p.320)

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. The Katter includes short-term investments such as government bonds and securities, commercial papers, certificate of deposits etc. Mutual fund provides the investor with professional management of funds and diversification of investment.
Mutual funds are intermediaries for investing in stock market scrips on behalf of investors, comparatively having smaller savings (money) and smaller knowledge of investing in stock market. Mutual funds invest in diversified and managed portfolio of customer’s (Investor) choice. Here customers’ choice means the objectives of investments such as, whether investors are willing for a regular income through their investment or capital appreciation or tax-relief or higher yield etc. Mutual funds actually provide their services of fund-management which results in diversified portfolio. In one sense a mutual fund is an Asset Management Company known as AMC, which provides services for some consideration.

1.2 THE CONCEPT OF MUTUAL FUNDS ON THE GLOBE

The concept of mutual funds on Globe have been developed in Netherlands in 1822 by King William I as the first mutual fund as open-end investment company. But there has been uncertainty about this origin since some others point to a Dutch Merchant Adriaan van Ketwich, who have created his investment trust in 1774, ketwich have given the theory that diversification may increase the appeal of investments to the smaller investors with minimal capital. The name of ketwich’s fund was “EendragtMaaktmagt”, which means, unity creates strength”. Following it similar kind mutual funds, includes an investment trust launched in Switzerland in 1849 followed by similar vehicles created in Scotland in 1880s.

1.3 ORIGIN OF THE CONCEPT OF MODERN MUTUAL FUNDS

Modern Mutual Fund was first created in 1924 in Massachusetts, as Massachusetts investors trust in Boston. The fund went public in 1928. This was, later on, known as MFS Investment mgt. 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 paw Cabot at the Holm Saltonstall was also affiliated with scudder, Stevens and dark, the fund that launched the first no load fund in 1928. In the same year the first mutual fund to include stock and bonds, namely Wellington fund. It was launched just as to direct merchant bank style of investments in business and trade. Starting of Regulation and Expansion at global level by 1929, there were 19 open ended mutual funds competing with nearly 700 close-end funds with the stock market crash of 1929, the dynamic began to change as
highly-leveraged closed-end fund were wiped out and small open-end funds managed to survive. Govt. also began to indulge in the system. It was made necessary to registered with Securities and Exchange Commission (SEC) the passage of securities act of 1933. It was made mandatory to disclose the relevant facts in the forms of prospectus. Securities Exchange Act was also enacted in 1934. The Investment company act of 1940 put in place additional regulations that required more regulations those required more disclosures and to sought to conflicts of interest. At the beginning of the 1950s, the number of open-end funds topped 100. In 1954, the financial markets overcame their 1929 peak, and mutual fund industry began to grow. It also added 50 new funds over the decade. In 1960s there was witnessed the rise of aggressive growth funds, with more than 100 new funds established and billions of dollars established and billions of dollars in new asset inflows. Several new funds were launched throughout the 1960s until the bear market of 1969 cooled the public appetite for mutual funds. In US alone there are more than 10000 mutual funds.

1.4 IMPORTANT PHASES OF MUTUAL FUNDS INDUSTRY IN INDIA

In India, mutual funds concept has been pioneered with the establishment of UTI act 1963. In 1964, since the establishment of UTI was the single player as mutual funds in India. It exercised its monopoly till 1986 (64-86). This period is also termed as first phase of mutual fund Industry of India. SBI Mutual fund was entered as the first bank-sponsored mutual fund under the public sector in 1987. So second phase of (1987-1992), SBIT MF, Canbank MF, LIC, GIC, nationalized banks entered the industry as operating wholly owned mutual fund subsidiary. The third phase of the Indian mutual fund industry (1992-97) was a landmark since the regulation of all mutual funds, except UTI, was taken up by SEBI. This step was quite enough to bring the confidence of potential mutual fund investors or simply investors towards these mutual fund investments. But till then UTI was not taken-up by the SEBI for regulation one another important step was taken in this phase, to develop the mutual fund industry in India, by setting up a non-profit organization ASSOCIATION OF MUTUAL FUNDS IN INDIA (AMFI). In the same year it have become compulsory for mutual funds to get registered under SEBI rules and regulations Establishment of AMFI was backed by the motive of safeguarding the interest of investors. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private
sector mutual fund registered in July 1993. The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996.

The fourth phase remained since 2002. In fourth phase the operating environment for UTI became more complex and tough, just because of in Feb. 2003 it have been bifurcated into two parts UTI was bifurcated as one part the SPECIALIZED UNDERTAKING OF THE GOVT. and another part UTI MUTUAL FUNDS INDIA LTD. Now all the pending schemes of US-64 and some other schemes were to be managed by the specialized undertaking of govt. covering Rs. 47300 crore AUM. UTIMF had to manage the assets worth Rs.76000crore. The Indian domestic market also has major impact of increasing rupee against major international currencies, The Indian rupee appreciated almost by 2.27% for the quarter ending September 2007. The Rupee climbed highest on 19th August at 41.34 and lowest on Sep 27 at 39.71.

After studying these phases, we can say the Indian mutual fund industry is growing since as in 1964 there was only one player in the industry, but in 2008 there have been aggregate 46 all the sectors have indulged themselves, for taking part in the industry. Mostly banks and financial institutions have taken the steps to enter into.

Mutual funds have emerged as an important player of financial system/ market in India, especially after the initiatives taken by the government in 1999-2000 Budget to resolve problems associated with UTI’s US-64 scheme. It was merged to give benefits under tax law through investments if made in mutual funds.

1.5 MUTUAL FUNDS AND TAX BENEFITS

By liberalizing the tax- treatments of income earned through mutual fund, importance and role of mutual funds increased in channeling the funds / savings of big portion of population of India. The year, 1999-2000 has provided the mutual fund industry of India with several innovations. The monetary and credit policy of this year have permitted money – market mutual funds to offer cheque writing facility to unit holders. Some of the mutual funds have introduced limited facility for cheque-writing available to unit –holder only against savings accounts and with some designated banks only in the mid of the same year (1999-2000) permitted the scheduled
commercial banks to offer “cheque writing” facility to gilt funds and those liquid income schemes of mutual funds, which invest at least 80% of corpus in money market instruments. The same policy permitted mutual funds to undertake forward – rate agreement (FRA) / Interest rate swaps (IRS) with banks, primary dealers and financial institutions for the purpose of hedging their own balance –sheet risks. But at that time mutual funds were not allowed to undertake market – making in FRAs/ IRS. Another most significant development related to the emergence of sector funds targeting sectors such as information technology, pharmaceuticals, FMCG ( fast moving consumer goods) etc. Also the emergence of dedicated Gilt funds envisaging 100% investment in govt. securities, which has made the gilt – market accessible to small investor. Dematerialization of the securities was also enthusiast for the industry to move up.

1.6 RESOURCE-MOBILIZATION

Resource mobilization in an economics context can be taken as movement of money or money – equals from the non/less productive section to productive section. Here resources mean those sources which can alternatively be used in capital formation activities of financial system. A non – productive / less – productive section means people unaware of proper investing habits. In India this concept becomes more crucial because of its backward regional economy. Idlelity of money or in one sense hoarding of money was common habits of people in the rural economies, so rural economies were not able to participate in the financial system of country.

The Indian Economy has suffered the hard and harsh state of crisis, when it became almost impossible to be self reliant. The rusted economy then emerged itself in a quite new liberalized form to re-construct the ruined economy and financial system containing nearly billion of population. People unaware of capital market behavior and investment possibilities, normally don’t dare enter to the financial market. This ignorance leads to become unconfident to invest their limited sources. When the resources are limited obviously risk – bearing – capacity of individuals suffers. So as a results we can say, mutual funds may be meeting to both these preference safety of money and plus a regular income. So confidence of individuals can be placed in the small investors. The concept of resource mobilization has been increasing right after the second generation reforms. The LPG process which was imposed by IMF as a
condition to financially assist India brought growing avenues for India. Reserves which was empty in 1991 have touched $ 262 b on in 2008.In 2006, AUM of 30 funds rose by ₹ 1, 25,296 crore, or 63% to ₹3, 23,001 crore during the calendar year 2006. According to the date published by AMFI (Association of mutual funds in India) mutual funds saw a record mobilization as investors got enthusiastic to take the advantage of the stock market boom. My research is centered on how mutual funds are playing their role by channeling the saving of the investors (mainly retail) in to the investment in financial markets. According to Global Asset Management 2006 report from Boston consulting group, India – managed assets will exceed more than $ trillion by 2015. This indicates towards 20% annual growth rate for rest period with the entrance of new fund houses and introduction of new funds in to the market, investors have been presented with a wide variety of choices of mutual funds investment opportunities. Total assets under management were of mutual fund industry, in 1987 100 crores, which went up to 4100 crore in 1991 and in 1998 touched the Graph of 72000 crore. (P. HanumanthaRao and Vijay Kr. Mishra Vidyasagar University Journal of Commerce Vol. 12, March 2007).

In between August 2005 and August 2006 Assets under management of mutual funds in India grew 57% to over Rs. 3 lakhscore. Mutual funds, other than UTI, increased their share of household financial savings to 3.6% in 2005-06 from a measly 4% in preceding year (2004-05). Although in India the %age share of Assets under management are far behind from that of developed countries. In 2005 -2006 the AUM were nearly 9.5% as against 60% in developed countries.

As on March 2002, there were 35 mutual fund companies with 433 schemes and assets under management were 100594 (Rs. 1005 billion).

Definition of mutual fund, by Securities and Exchange board of India (mutual funds) Regulations, 1996, "a fund establishment in 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".
1.6.1 CHART-IGROWTH IN ASSETS UNDER MANAGEMENT

Source: AMFI data

It is commendable to note, that, Assets Under Management have managed to record a compounded growth of 28% over 2006-2010, however, the AUM of Equity Funds and Balanced Funds where retail investors invest have only grown by 20% in the same period. The net sales of Equity/Balanced funds in 2009-10 have been one of the lowest in recent years. India has vast growth potential backed by a resilient economy, commensurate with an accelerated GDP growth rate of 7.4%, high rate of household savings and investments. This report by PwC seeks to outline the current state of the industry, with its growth drivers and continuing challenges. It also seeks to draw a comparison with other global economies, the business and regulatory trends which have been impacting this industry with a snapshot of some of the regulatory changes anticipated around the corner. The mutual fund AUM as of September 2007 has seen a decline of almost Rs.9662crore or 2% when compared with July month asset under management. Of the total 33 Fund house 19 of them has witnessed negative trend in its AUM where as remaining fund house has witnessed positive trend, among which J P Morgan has witnessed maximum increase or around 101% which was closely followed by AIG Global Investment Group Mutual Fund which saw 100% increase in its AUM trend.
1.7 SEBI AND MUTUAL FUNDS

As far as mutual funds are concerned, SEBI formulates policies and regulates the mutual funds to protect the interest of the investors. SEBI notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All mutual funds whether promoted by public sector or private sector entities including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type. (http://www.sebi.gov.in)

1.7.1 THE PROCEDURE FOR REGISTERING A MUTUAL FUND WITH SEBI

An applicant proposing to sponsor a mutual fund in India must submit an application in Form A along with a fee of Rs.25,000. The application is examined and once the sponsor satisfies certain conditions such as being in the financial services business and possessing positive net worth for the last five years, having net profit in three out of the last five years and possessing the general reputation of fairness and integrity in all business transactions, it is required to complete the remaining formalities for setting up a mutual fund. These include inter alia, executing the trust deed and investment management agreement, setting up a trustee company/board of trustees comprising two-thirds independent trustees, incorporating the asset management company (AMC), contributing to at least 40% of the net worth of the AMC and appointing a custodian. Upon satisfying these conditions, the registration certificate is issued subject to the payment of registration fees of Rs.25.00 lacs. (http://www.sebi.gov.in)
1.8 ASSOCIATION OF MUTUAL FUNDS IN INDIA AND MUTUAL FUNDS

AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI. Till date all the AMCs are that have launched mutual fund schemes are its members. It functions under the supervision and guidelines of its Board of Directors. Association of Mutual Funds India has brought down the Indian Mutual Fund Industry to a professional and healthy market with ethical lines enhancing and maintaining standards. It follows the principle of both protecting and promoting the interests of mutual funds as well as their unit holders.

1.8.1 THE SPONSORERS OF ASSOCIATION OF MUTUAL FUNDS IN INDIA

Bank Sponsored

- SBI Fund Management Ltd.
- BOB Asset Management Co. Ltd.
- Canbank Investment Management Services Ltd.
- UTI Asset Management Company Pvt. Ltd.

Institutions

- GIC Asset Management Co. Ltd.
- JeevanBimaSahayog Asset Management Co. Ltd.

Private Sector

Indian:-

- BenchMark Asset Management Co. Pvt. Ltd.
- Cholamandalam Asset Management Co. Ltd.
- Credit Capital Asset Management Co. Ltd.
- Escorts Asset Management Ltd.
- JM Financial Mutual Fund
- Kotak Mahindra Asset Management Co. Ltd.
- Reliance Capital Asset Management Ltd.
- Sahara Asset Management Co. Pvt. Ltd
- Sundaram Asset Management Company Ltd.
• Tata Asset Management Private Ltd.

Predominantly India Joint Ventures:-

• Birla Sun Life Asset Management Co. Ltd.
• DSP Merrill Lynch Fund Managers Limited
• HDFC Asset Management Company Ltd.

Predominantly Foreign Joint Ventures:-

• ABN AMRO Asset Management (I) Ltd.
• Alliance Capital Asset Management (India) Pvt. Ltd.
• Deutsche Asset Management (India) Pvt. Ltd.
• Fidelity Fund Management Private Limited
• Franklin Templeton Asset Mgmt. (India) Pvt. Ltd.
• HSBC Asset Management (India) Private Ltd.
• ING Investment Management (India) Pvt. Ltd.
• Morgan Stanley Investment Management Pvt. Ltd.
• Principal Asset Management Co. Pvt. Ltd.
• Prudential ICICI Asset Management Co. Ltd.
• Standard Chartered Asset Mgmt Co. Pvt. Ltd.(www.amfiindia.com)

1.8.2 CHART-II Working of Mutual Fund

1.9 TYPES OF MUTUAL FUNDS SCHEMES IN INDIA
Wide variety of Mutual Fund Schemes exists to cater to the needs such as financial position, risk tolerance and return expectations etc. thus mutual funds has Variety of flavours, Being a collection of many stocks, an investors can go for picking a mutual fund might be easy. There are over hundreds of mutual funds scheme to choose from. It is easier to think of mutual funds in categories, mentioned below.

1.9.1 Overview of schemes existing in mutual fund category:

1. Open - Ended Schemes:

An open-end fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices. The key feature of open-end schemes is liquidity.

2. Close - Ended Schemes:

These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.

3. Interval Schemes:

Interval Schemes are that scheme, which combines the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

Overview of schemes existing in mutual fund category:
By nature:

1. Equity fund:

These funds invest a maximum part of their corpus into equities holdings. The structure of the fund may vary different for different schemes and the fund manager’s outlook on different stocks. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix.

2. Debt funds:

The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide suitable income to the investors. Debt funds are further classified as:

- Gilt Funds: Invest their corpus in securities issued by Government, popularly known as Government of India debt papers. These Funds carry zero Default risk but are associated with Interest Rate risk. These schemes are safer as they invest in papers backed by Government.
- Income Funds: Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.
- Monthly Income Plans: MIPs Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk-return matrix when compared with other debt schemes.
- Short Term Plans (STPs): Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of
Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.

- Liquid Funds: Also known as Money Market Schemes, These funds provide easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.

3. Balanced funds:

As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns. Further the mutual funds can be broadly classified on the basis of investment parameter viz, Each category of funds is backed by an investment philosophy, which is pre-defined in the objectives of the fund. The investor can align his own investment needs with the funds objective and invest accordingly.

**By investment objective:**

- Growth Schemes: Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.

- Income Schemes: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.

- Balanced Schemes: Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they
earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents.

- **Money Market Schemes:** Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.

**Other schemes**

- **Tax Saving Schemes:** Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec.88 of the Income Tax Act, contributions made to any Equity Linked Savings Scheme (ELSS) are eligible for rebate.

- **Index Schemes:** Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.

- **Fund of fund scheme:** A fund of fund scheme means a scheme that invests primarily in other schemes of the same mutual fund or other mutual fund (www.sbimf.com).

- **Sector Specific Schemes:** 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. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time. (MutualFundsIndia.com)
1.10 Advantages of Investing In Mutual Funds

1. Professional Management - The basic advantage of funds is that, they are professional managed, by well qualified professional. Investors purchase funds because they do not have the time or the expertise to manage their own portfolio. A mutual fund is considered to be relatively less expensive way to make and monitor their investments.

2. Diversification - Purchasing units in a mutual fund instead of buying individual stocks or bonds, the investors risk is spread out and minimized up to certain extent. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others.

3. Economies of Scale - Mutual fund buy and sell large amounts of securities at a time, thus help to reducing transaction costs, and help to bring down the average cost of the unit for their investors.

4. Liquidity - Just like an individual stock, mutual fund also allows investors to liquidate their holdings as and when they want.

5. Simplicity - Investments in mutual fund is considered to be easy, compare to other available instruments in the market, and the minimum investment is small. Most AMC also have automatic purchase plans whereby as little as Rs. 2000, where SIP start with just Rs.50 per month basis.

1.11 Disadvantages of Investing In Mutual Funds

1. Professional Management - Some funds don’t perform in either 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. Costs – The biggest source of AMC income is generally from the entry & exit load which they charge from investors, at the time of purchase. The mutual fund industries are thus charging extra cost under layers of jargon.

3. 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.
4. 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. (MutualFundsIndia.com)

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