OBJECTIVES OF THIS CHAPTER

This chapter discusses in details the research work undertaken in regard to conceptualizing:

- *What are the different types of mutual fund schemes available for investments by retail investors?*
- *What are the different types of asset classes in which the mutual fund schemes invest?*
- *How do mutual fund schemes perform in comparison to the other types of retail investment products (small savings scheme)?*
2.1 INTRODUCTION TO MUTUAL FUNDS

2.1.1 Meaning

A mutual fund is a trust that pools the investors’ savings having same common financial goals. Money collected from investors is then invested in various financial securities like shares, debentures, bonds and others. The income earned through these investments and the capital appreciation realized is shared by the investors in proportion to the investment made by them.

2.1.2 Definition

A mutual fund is a type of professionally managed, collective investment vehicle that pools money from many investors to invest in different markets and securities according to the stated investment objectives agreed upon between the mutual fund and the investors. (Refer to Figure 2.1.2.1 for a diagrammatic explanation of the concept of Mutual Fund).

2.1.3 Role

The primary role of mutual fund is to assist investors in earning an income or building the wealth by participating in the opportunities available in various securities and markets. As an alternate role, mutual fund also benefits the government (by boosting taxes), the companies or other entities (by funding projects), the society (by enhancing higher employment & check on corporate governance and ethical standards of the investee company) and lastly the financial markets (by stabilizing large inflow and outflow of funds).

2.1.4 Structure & Important Terms

“Mutual fund” or “the fund” refers to an entity. This entity floats a “scheme” or “fund” for any kind of investment objective and raises large corpus of money from diverse investors. The share of each investor in a particular scheme is denominated by “units”. In case an investor had invested money in the scheme at the time of initial offering then the number
of units held by the investor multiplied by its “face value” (usually ₹ 10/-) is the capital invested by the investor. In case the investor had invested money in the scheme post its initial offering then the number of units held by the investor multiplied by the “net asset value” (at the time of purchase) is the capital invested by the investor. The number of units held by a particular scheme multiplied by its face value (₹ 10/-) is the capital invested in that particular scheme which is also known as “unit capital”. A scheme invests its unit capital in multiple “securities” as per the stated investment objective of the particular scheme. The decision regarding the latter is taken by the “Fund Manager” based on the investment objective of the particular scheme. The market value of each unit is known as “Net Asset Value (NAV)” which is determined as follows:

\[
\text{Net Asset Value (NAV)} = \text{Interest income} + \text{Dividend income} + \text{Realized capital gains} + \text{Valuation gains (unrealised capital gain)} - \text{Realized capital losses} - \text{Valuation losses (unrealised capital loss)} - \text{Scheme expenses}.
\]

The net asset value is calculated from the net assets. The net assets represent the market value of assets which belong to the investors, on a given date. Net assets are calculated as:

- **Market value of investments**
  - (+) Current assets and other assets [Realised gain / Valuation gain]
  - (+) Accrued income [Interest income / Dividend]
  - (-) Current liabilities & other liabilities [Realised Loss / Valuation Loss]
  - (-) Accrued expenses [Scheme expenses]

Subsequently net asset value is calculated as net assets divided by total number of units issued.

When a scheme is first made available for investment, it is called a “New fund offer (NFO)”. During the NFO, investors usually 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 equal
to the ongoing net asset value. Profits or losses belongs to the investors, however investor does not bear a loss higher than the amount invested by him/ her. The relative size of a scheme of a mutual fund company is assessed by its “Assets under management (AUM)”. The current AUM of a scheme is the unit capital multiplied by its current net asset value. When a scheme is first launched, assets under management would be the amount mobilized from investors. Thereafter, if the scheme has a positive profitability metric, its AUM goes up. In case of a negative profitability metric, AUM goes down. Moreover, if the scheme is open to receiving or redeeming money from investors post NFO, then also the AUM fluctuates (Refer to Figure 2.1.4.1 for a diagrammatic representation of the sequence of activities mentioned above).

Some other important terms in this regard are as follows:

**Mark to market**: The process of valuing each security in the investment portfolio of the scheme at its market value is called ‘mark to market’. The net asset value is meant to reflect the true worth of each unit of the scheme, because investors buy or sell units on the basis of the net asset value. Thus, marking to market helps investors buy and sell units of a scheme at fair price.

**Sale price and repurchase price**: Sale price is the price to acquire new units from the scheme.

- Sale price = NAV + Entry Load

On the other hand, repurchase price is the price to sell units back to the scheme.

- Repurchase price = NAV – Exit Load

**Loads**: Load is an amount which is recovered from the investor. Load is charged to investor when the investor buys or redeems units. It is primarily used to meet the expenses related to sale and distribution of units. Load charged on sale of units is entry load. It increases the price above the net asset value for new investor. Load charged on redemption is exit load.
It reduces price. A no load Fund is one in which the initial issue expenses are not charged to the investors.

Previously maximum entry load or exit load was 7% (for open ended funds) and 5% (for closed ended funds). Earlier, schemes had the flexibility to differentiate between different classes of investors within the same scheme, by charging them different levels of load. Further, all the moneys collected as loads were available for the asset management company to bear various selling expenses. Since 1st August 2009, SEBI has banned all forms of entry loads. So, the sale price needs to be the same as net asset value.

**CDSC.** It is known as contingent deferred sales charges. CDSC is an exit load that varies with holding period. It is less for investors who stays longer in the fund. Exit loads/ CDSC are maximum 1%. Charges in excess of 1% of the redemption proceeds have to be credited back to the scheme immediately i.e. they are not available for the asset management company to bear selling expenses. Exit load structure needs to be the same for all unit holders representing a portfolio.

### 2.1.5 Expenses

**Initial issue expenses.** Expenses that are incurred in the launch of the fund [NFO] are called as initial issue expenses. They are one-time expenses. Nowadays these expenses are to be borne by the asset management company; it has no effect on the net asset value.

Previously, schemes could charge initial issue expenses to the scheme, upto 6% of the amount mobilized in the NFO. If the entire issue expenses were treated as an immediate expense (in accounting terminology, such expensing is called “written off”), it would cause severe drop in net asset value. Hence the IIE was permitted to be amortised over the life of the scheme [Maximum up to 5 years] to prevent immediate fall in net asset value. Part of the initial issue expense that related to periods that have passed were written off (which
used to reduce the net asset value). The part that related to a future time period was treated as an asset of the scheme, called “issue expenses not written off”.

**Recurring expenses**: Expenses that are incurred regularly in the operational process of the fund are called recurring expenses. These are of the nature of regular expenses. These can be charged to the scheme and hence may drag down the net asset value. They may be of the following types:

- Investment management fees to the asset management company
- Custodian’s fees
- Trustee fees
- Registrar and transfer agent fees
- Marketing and distribution expenses
- Operating expenses
- Audit fees
- Legal expenses
- Cost of mandatory advertisements & communications to investors

It is to be noted that the asset management company cannot charge all the expenses that it incurs to the income of the fund. There are two levels of restrictions.

At the first level only certain kinds of expenses that are identified as having been incurred for the conduct of the business of the fund can be charged to the fund.

The second level of regulation refers to the limit on the total expenses that can be charged to the fund (Refer to Table 2.1.5.1).

The investment management and advisory fees charged by the asset management company are regulated by SEBI as follows.

- For the first ₹ 100 Cr. of net assets. 1.25%
- For the net assets exceeding ₹ 100 Cr. 1.00%
The expense limits for index schemes (including Exchange Traded Funds) is as follows:

- Recurring expense limit (including management fees) 1.50%
- Management fees 0.75%

As regards fund of funds, the recurring expense limit (including management fees) is 0.75%.

The following expense however cannot be charged to the scheme:

- Penalties and fines for infraction of law.
- Interest on delayed payment.
- Legal, marketing & other general expenses not attributable to any scheme.
- Expenses on general administration corporate advertising and infrastructure costs.
- Depreciation on fixed assets.

There are certain other charges applicable as well (Refer to Table 2.1.5.2).

**Additional expenses.** Since September 13, 2012, funds can charge additional expense of up to 30 basis points on daily net assets of the scheme if the new inflows from beyond top 15 cities are at least:

- 30% of gross new inflows in the scheme or
- 15% of the AAUM (year to date) of the scheme, whichever is higher

In case inflows from beyond top 15 cities is less than the higher of both the two above parameters, ten an additional total expense on daily net assets of the scheme shall be charged. The same would be calculated as \( \frac{(\text{Daily net assets} \times 30 \text{ basis points} \times \text{New inflows from beyond top 15 cities})}{(365 \times \text{Higher of the two above})} \). These regulations are an attempt to increase the reach of the mutual fund industry in the country.

2.1.6 **ADVANTAGES**

The advantages of investment in mutual fund schemes are as follows:

- Professional management
• Portfolio diversification
• Reduction in transaction cost through economies of scale
• Reduction in risk
• Liquidity
• Tax deferral
• Tax benefits
• Convenient options
• Investment comfort
• Regulatory comfort
• Systematic approach to investments [SIP / SWP / STP]

2.1.7 Disadvantages

The disadvantages of investment in mutual fund schemes are as follows:

- Lack of portfolio customization
- Choice overload
- No control over costs

2.1.8 Current Industry Status

The “Average Assets Under Management (AAUM)” of the industry, as on 28th February 2017 stood at ₹ 17.89 lakh crores under 43 active mutual fund players.

2.2 Categories & Subcategories of Mutual Fund Schemes

Based on availability of purchase and sale of mutual fund units, they can be classified in the following three types:

- Open Ended Funds
- Close Ended Funds
- Interval Funds
2.2.1.1 **Open Ended Funds**

In an open ended fund, investors can buy and sell units of the fund, at net asset value related prices, at any time, directly from the fund house/ asset management company. Open ended scheme are offered for sale at a pre-specified price, say ₹ 10, during the new fund offer period. After 5 business days post the NFO period, the fund is declared open for further purchases and re-purchases. The number of outstanding units goes up or down or account of the latter. The unit capital is not fixed but variable. The AUM of an open-ended scheme changes every day. When existing investors buy additional units or new investors buy units of the open ended scheme, it is called a purchase transaction. It happens at a sale price, which is equal to the net asset value. When investors choose to return any of their units to the scheme and get back their equivalent value, it is called a repurchase transaction. This happens at a repurchase price that is linked to the net asset value.

2.2.1.2 **Close Ended Funds**

A closed end fund is open for sale to investors for a specified period (NFO), after which further sales are closed. Any further transactions happen in the secondary market (stock exchange) where closed-end funds are usually listed. The price at which the units are sold or redeemed depends on the market prices, which are fundamentally linked to the net asset value. The number of outstanding units remains unchanged. The unit capital is therefore fixed due to onetime sale. However the AUM of a close-ended scheme changes every day.

Listing of close ended schemes. Every close ended scheme, other than an equity linked savings scheme, shall be listed on a recognised stock exchange within such time period and subject to such conditions as specified by the Board.
Provided that listing of close ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 shall not be mandatory.

a) if the said scheme provides for periodic repurchase facility to all the unit holders with restriction, if any, on the extent of such repurchase; or

b) if it provides for monthly income or caters to special classes of persons like senior citizens, women, children, widows or physically handicapped or any special class of persons providing for repurchase of units at regular intervals; or

c) if the details of such repurchase facility are disclosed in the offer document; or

d) if it opens for repurchase on a period of six months from subscription closure; or

e) if the said scheme is a capital protection oriented scheme.

2.2.1.3 INTERVAL FUNDS

Interval funds combine features of both open ended and close ended schemes. They are largely close ended, but become open ended at pre specified intervals. The benefit for investors is that, unlike in a purely close ended scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund. Minimum duration for interval funds is usually 15 days & minimum specific transaction period is usually 2 working days.

Based on the nature of fund management styles, they can be classified in the following two types:

- Actively Managed Funds
- Passively Managed Funds

2.2.2.1 ACTIVELY MANAGED FUNDS

In cases of actively managed funds, the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective. The
expenses for managing such funds turn out to be higher. Investors expect actively managed funds to perform better than the overall market as represented by a broad market index.

**2.2.2.2 PASSIVELY MANAGED FUNDS**

A passive fund manager believes that holding a well diversified portfolio is a cost efficient way to better returns. Thus, he/she would tend to mimic the market index. In cases of passively managed funds, the fund manager invests on the basis of a specified index, whose performance the scheme seeks to track. The proportion of each share in the portfolio of the scheme would also be the same as the weightage assigned to the respective share in the computation of the index. Such a strategy requires limited research and monitoring costs. Thus the expenses for managing such funds turn out to be quiet low, as fund manager has no active role. Investors expect same return as the target index. Any deviation in returns is called “Tracking Error”. A passive fund manager has to rebalance the portfolio every time changes are made in the index.

*Based on kind of underlying assets, mutual funds can be classified in the following five types:*

- *Equity Funds*
- *Debt Funds*
- *Hybrid Funds*
- *Gold Funds*
- *Other Funds*

**2.2.3.1 EQUITY FUNDS**

Mutual fund schemes which invest at least 65% of their assets under management in equity shares and/or related instruments are known as equity funds. The different types of equity mutual funds are as follows.
• Diversified Equity Funds
• Equity Linked Savings Schemes (ELSS)
• Large Cap Equity Funds
• Mid Cap Equity Funds
• Small Cap Equity Funds
• Index Funds
• Sectoral Funds
• Thematic Funds
• Foreign Securities Funds
• Arbitrage Funds
• Growth Funds
• Value Funds
• Equity Income / Dividend Yield Funds

2.2.3.1.1 Diversified Equity Funds

Equity funds which invest in a diverse mix of securities across different sectors.

2.2.3.1.2 Equity Linked Savings Schemes (ELSS)

Investments in these funds are eligible for income tax deduction under section 80C up to ₹1 lakh. The investments in these funds have a 3 year lock in period. For such funds, minimum investment of 90% in equity markets at all times is mandatory.

2.2.3.1.3 Large Cap Equity Funds

They invest in equity shares of large cap companies i.e. companies whose stocks have an average free float market capitalization which ranges above ₹1,000 crores.
2.2.3.1.4 **Mid Cap Equity Funds**

They invest in equity shares of mid cap companies. Mid cap companies refer to companies whose stocks have an average free float market capitalization ranging from ₹ 200 crores to ₹ 1,000 crores.

2.2.3.1.5 **Small Cap Equity Funds**

They invest in equity shares of small cap companies. Small cap companies refer to companies whose stocks have an average free float market capitalization ranging up to ₹ 200 crores.

2.2.3.1.6 **Index Funds**

These are equity funds that attempt in replicating a broad based or a sectoral index e.g. NIFTY, Sensex, CNX 100 etc.

2.2.3.1.7 **Sectoral Funds**

These are equity funds that invest in securities of a specific sector e.g. retail, FMCG, banking and financial services etc.

2.2.3.1.8 **Thematic Funds**

They invest in line with an investment theme. Say for example, Infrastructure thematic fund invests in equity shares of companies like construction, cement, power telecom etc.

2.2.3.1.9 **Foreign Securities Funds**

They invest in shares of different countries to make it more diversified.

2.2.3.1.10 **Arbitrage Funds**

These funds take contrary positions in different markets / securities, such that the risk is neutralized, but a return is earned. It’s done by buying shares in one exchange (say BSE) at a lower price and simultaneously selling the same shares in another exchange (say NSE) at a higher price. Arbitrage Funds also take contrary positions between the cash market and the derivatives market.
2.2.3.1.11  **Growth Funds**

These equity funds are managed with an objective of generating capital appreciation over 3 to 5 years at an above average rate. They essentially invest in companies that are experiencing high growth rate in their operations and financials.

2.2.3.1.12  **Value Funds**

The investment style of these equity funds is to invest in the companies whose shares are currently underpriced and thereby securing above average return for the investors.

2.2.3.1.13  **Equity Income/ Dividend Yield Funds**

They invest in securities with lower fluctuation and higher dividend yield. Hence, for these funds, dividend represents a larger proportion of the returns generated.

2.2.3.2  **Debt Funds**

Mutual fund schemes which invest majority of their assets under management in fixed income and/ or related instruments are known as debt funds. The different types of debt mutual funds are as follows:

- Gilt Funds
- Diversified Debt Funds
- Fixed Maturity Plans
- Floating Rate Funds
- Liquid/ Money Market Funds
- Junk Bond Schemes

2.2.3.2.1  **Gilt Funds**

“Gilt” means Government securities. Such funds invests only in securities that are issued by the Government and therefore do not carry any credit/default risk.

2.2.3.2.2  **Diversified Debt Funds**

These funds invest in a mix of government and non government debt securities.
2.2.3.2.3  **FIXED MATURITY PLANS**

They are closed ended in nature. They are usually for short term i.e. less than a year and are likely to be an income scheme. They are not listed on a stock exchange. They act as an alternate of bank deposits/ corporate deposits.

2.2.3.2.4  **FLOATING RATE FUNDS**

Such funds invest largely in floating rate debt securities i.e. debt securities where the interest rate payable by the issuer changes in line with the market interest rate. The net asset values of such schemes fluctuate lesser than debt funds that invest more in debt securities offering a fixed rate of interest.

2.2.3.2.5  **LIQUID/MONEY MARKET FUNDS**

These debt funds invest only in instruments with maturities less than 61 days (previously the time frame was one year). Such funds are lowest in the order of risk level and hence are ideal for very short term investors.

2.2.3.2.6  **JUNK BOND SCHEMES**

They invest in companies that are of poor credit quality but offering high yield bonds. So return can be attractive, though there are significant credit risks.

2.2.3.3  **HYBRID FUNDS**

Hybrid fund schemes invest a part of their assets under management in equity and related instruments and the remaining part in fixed income and/or related instruments. The different types of hybrid mutual funds are as follows:

- Monthly Income Plans
- Capital Protected Plans
2.2.3.3.1 Monthly Income Plans

Monthly income plan seeks to declare a dividend every month, however that is not guaranteed. It invests largely in debt securities. However, a small percentage is invested in equity shares to improve the scheme’s yield.

2.2.3.3.2 Capital Protected Plans

Capital Protected Plans are structured to ensure that investors get their principal back, irrespective of what happens to the market. This is ideally done by investing in Zero Coupon Government securities whose maturity is aligned to the scheme’s maturity. These are close-ended funds. Capital protection can also be offered through a guarantee from a guarantor, who has the financial strength to offer the guarantee. Such schemes are however not prevalent in the market.

2.2.3.4 Gold Funds

Mutual fund schemes which invest majority of their assets under management in gold or companies that invest in gold are known as gold funds. The different types of gold mutual funds are as follows.

- Gold Exchange Traded Funds
- Gold Sectoral Funds

2.2.3.4.1 Gold Exchange Traded Funds

Gold exchange traded funds are like an index fund that invests in gold. The net asset value of such funds moves in line with gold prices in the market.

2.2.3.4.1 Gold Sectoral Funds

Gold Sector Funds invests in equity shares of companies engaged in gold mining and processing, therefore net asset value of these funds do not reflect gold prices.

Note: It is actually an equity fund and has been discussed here to highlight the differences from a Gold ETF.
2.2.3.5 **Other Funds**

Mutual fund schemes which cannot be classified as equity, debt, hybrid or gold funds are known as other funds. They are comprised of the following funds:

- Real Estate Funds
- Commodity Funds
- International Funds
- Fund of Funds
- Exchange Traded Funds (ETF)

2.2.3.5.1 **Real Estate Funds**

These funds take exposure to real estate. Though permitted by law, they are no such funds available at present.

2.2.3.5.2 **Commodity Funds**

They invest directly into commodities/ shares of the commodity companies/ commodity futures contract. In India mutual funds are not permitted to invest directly in commodities (other than Gold), so we have only ‘Commodity Sector Funds’ investing in shares of companies that are into commodities. Hence these funds can be classified as Equity Fund.

2.2.3.5.3 **International Funds**

They invest outside the country. Usually they invest in a foreign fund (host fund) where money is sourced from a domestic fund (feeder fund). The investment could be in a specific country or diversified across countries. The feeder fund converts the Indian rupee into foreign currency for investing abroad. Hence there also exists foreign currency risk.

2.2.3.5.4 **Fund of Funds**

These funds are structured to invest in various other funds, whether in India or abroad. An investor invests in a fund of funds, which in turn will manage the investments in various schemes and options in the market, and thereby reduce the ‘fund manager risk’.

Page No: 66
In case of a fund of funds scheme, the total expenses of the scheme including the management fees shall be either:-

i. Not exceeding 0.75% of the daily or weekly average net assets, depending upon whether the net asset value of the scheme is calculated on daily or weekly basis; or

ii. It may consist of -

A. Management fees for the scheme not exceeding 0.75% of the daily or weekly average net assets depending upon whether the net asset value of the scheme is calculated on daily or weekly basis;

B. Other expenses relating to administration of the scheme; and

C. Charges levied by the underlying schemes.

Provided that the sum total of (A), (B) and the weighted average of the total expense ratio of the underlying schemes shall not exceed 2.50% of the daily or weekly average net assets (depending upon whether the net asset value of the scheme is calculated on daily or weekly basis) of the scheme.

2.2.3.5.5 Exchange Traded Funds

ETF combines the best features of open end and closed structure. It tracks a market index and trades like a stock on the stock market. Buying & selling of units from the mutual fund is available only to very large investors. They appoint market makers to buy and sell units on the secondary market to meet the demand and supply from investors. Such shortfall of units or cash is thereafter adjusted against the ETF fund. ETFs are not same as index funds and are more cost effective than index funds.

Based on the different types of plans offered by the mutual fund, the mutual fund schemes can be classified in the following four types:

- Growth Funds
- Dividend Payout Funds

Page No: 67
Performance of Select Large Cap Mutual Fund Schemes during Bear and Bull Phases of Indian Securities Markets: An Empirical Study

Chapter 2: Mutual Fund

- **Dividend Reinvestment Funds**
- **Insurance Funds**

### 2.2.4.1 Growth Funds
Investors in this type of funds do not receive dividend. The appreciation in the portfolio is realised only through the capital appreciation on the investment which gets reflected by an increase in net asset value.

### 2.2.4.2 Dividend Payout Funds
Investors in this type of funds receive dividend on account of any appreciation in the portfolio. However, the net asset value of the scheme falls to the extent of the dividend payout.

### 2.2.4.3 Dividend Reinvestment Funds
In this type of funds the dividend accrued on account of any appreciation in the portfolio is automatically re-invested in purchasing additional units in the same scheme. However, in most cases the fund offers the investor an option of collecting dividends or re-investing the same.

### 2.2.4.4 Insurance Funds
In this type of funds the fund offers to provide insurance coverage to the investor as an additional option.

For a summarised representation of the discussions in this section refer to Figures 2.2.4.1 & 2.2.4.2.

### 2.3 Constituents of Mutual Funds

#### 2.3.1 Mutual Fund Regulator
Mutual funds in India are governed by SEBI (Mutual Fund) Regulations, 1996, as amended till date. Indian mutual funds are established as trusts that raise money through sale of
units to public under one or more schemes and invest the accumulated money in securities.

As per the current regulations, mutual funds can invest in:

i. Securities including money market instruments

ii. Gold or gold related instruments e.g. Gold ETF

iii. Real estate assets.

Wherever applicable, mutual funds need to comply with other market regulators like RBI, Stock exchanges etc.

2.3.2 Spons or

A sponsor is the promoter of the mutual fund. It makes application to SEBI for registration of a mutual fund. It creates the trust and appoints the asset management company.

The following eligibility criteria for a sponsor are essential.

A. 5-year track record in any Financial services business

B. Positive net worth (share capital plus reserves minus accumulated losses) for each of those 5 years

C. Latest net worth should be more than the amount that the sponsor contributes to the capital of the asset management company.

D. 3-year profit (NPAT) making record, including the latest year.

E. Minimum 40% holding of asset management company’s share capital besides anyone holding more than 40% of asset management company’s share capital should fulfil the above eligibility criteria.

2.3.3 Trustee

In India mutual fund is the form of a public trust created under the Indian Trust Act 1882. Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund. They have a fiduciary
responsibility for investor funds, legally investors are owner of their own funds. Trustees are appointed by sponsor with SEBI approval. The operations of the mutual fund trust are governed by a trust deed, which is executed by the sponsors. SEBI has laid down various clauses that need to be part of the trust deed. The third schedule of the SEBI regulations specifies the content of the trust deed. The trust acts through its trustees. Therefore, the role of protecting the beneficiaries (investors) is that of the trustees.

2.3.4 **Asset Management Company**

Asset management companies are usually structured as a private limited company where sponsors and associates hold the major share capital. An asset management company is appointed by the sponsor or the trustees. The asset management company overlooks the day to day operations & business aspects of the mutual fund. The asset management company signs the “investment management agreement” with the trustees. The asset management company is registered with SEBI. The asset management company needs to have a minimum of ₹ 10 crores of net worth at all times. Prior approval of the trustees is required, before a person is appointed as director on the board of the asset management company. At least $\frac{1}{2}$ of the directors should be independent. An asset management company cannot invest in its own schemes, unless the intention to invest is disclosed in the offer document. Further, the asset management company cannot charge any fees for the investment. It cannot indulge in any other business, other than that of asset management. The asset management company of one mutual fund cannot be trustee of another mutual fund. The 4th schedule of SEBI regulations spells out rights and obligations of both trustees and asset management companies. Any change in the asset management company is subject to prior approval of SEBI and the unit holders. The appointment of an asset management company can be terminated by a majority of the trustees, or by 75% of the
unit holders. The asset management company appoints other constituents of the mutual fund company.

2.3.5 **Custodian**

A custodian has custody of the assets of the fund. He/ she accept and give delivery of securities based on purchase and re-purchase. He/ she also track dividends, bonus and rights. He/ she are responsible for the securities held in the portfolio of the mutual fund and are required to be registered with SEBI. Custodian is appointed by the asset management company. For any mutual fund, the custodian and the sponsor cannot be the same entity. Sponsors and its associates cannot control 50% or more of the shares/directors of a custodian.

2.3.6 **Registrar And Transfer Agents**

They are responsible for maintaining investor records. An asset management company can handle this activity in-house or appoint them. Their other services include processing of applications of the investors, recording the details of the investors, sending information to investors, processing dividend payout, incorporating changes in investor information, keeping Investor information up to date etc.

2.3.7 **Auditor**

The auditor is responsible for audit of accounts. The books of accounts of the asset management company & the mutual fund scheme should be different. Similarly, the auditors for the asset management company & the mutual fund scheme should be different. The auditor for the asset management company is appointed by the asset management company itself while the auditor for the mutual fund schemes is appointed by the trustees.
2.3.8 Distributors

Distributors sell units of mutual fund scheme for a commission. Distributors need to pass the certification test and register with AMFI in order to do so. Banks and post offices also act as distributors. Sponsor or an associate can also act as a distributor for the asset management company. The commission received by the distributors is split into initial (upfront) commission which is paid on mobilization of funds and deferred (trail) commission which is paid depending on the time the investor stays with the fund. The asset management company, as the business face, fixes the terms & commission rates for distributors with approval from SEBI.

2.3.9 Banks

Bank maintains the bank accounts of the mutual fund schemes. It is appointed by the asset management company. Purchases & re-purchases applications are banked through the banker.

For a summarised representation of the discussions in this section refer to Figure 2.3.9.1.

2.4 Tax Provisions Relating To Mutual Fund Investments

2.4.1 Categories of Schemes

In respect of taxation provisions, mutual fund schemes are divided into two categories. Any mutual fund scheme that has 65% or more exposure to equity and equity related instruments is classified as an equity scheme. Else it is classified as a debt scheme. Income earned by any mutual fund registered with SEBI is exempt from tax (mutual fund being a trust) under section 10 (23D). The dividends are tax free in the hands of unit holders but it is liable to dividend distribution tax in case of closed ended fund and debt funds.

2.4.2 Taxation of Equity Schemes

For equity mutual fund schemes, dividends received are tax free in the hands of the investor. Moreover, for the mutual fund, dividend distribution tax on dividends declared
on equity mutual fund scheme is nil. Any capital gain made by the investor on an equity mutual fund scheme will be classified either as a short term capital gain or a long term capital gain depending on the period of holding. Short term capital gains on equity mutual fund schemes are taxed at 15% while long term capital gains are tax free.

2.4.3 Taxation of Debt Schemes

For debt mutual fund schemes, dividends received are tax free in the hands of the investor. However, for the mutual fund, dividend distribution tax on dividends declared on debt mutual fund scheme is taxable. Any capital gain made by the investor on a debt mutual fund scheme will be classified either as a short term capital gain or a long term capital gain depending on the period of holding. A capital gain that arises within 12 months of the period of holding is referred to as a short term capital gain whereas a capital gain that arises after 12 months of the period of holding is referred to as a long term capital gain. Short term capital gains on equity mutual fund schemes are taxed as per the marginal tax rate while long term capital gains are taxed either at 10% or at 15% (post indexation).

2.4.4 Securities Transaction Tax

Securities transaction tax is levied on certain types of transactions undertaken in the financial markets. The sale and purchase of units in equity oriented scheme of mutual fund is subject to securities transaction tax at the prescribed rate (Refer to Tables 2.4.4.1 & 2.4.4.2). However, if this securities transaction tax is not paid, then the equity schemes will be taxed as debt schemes. The securities transaction tax is not payable on transactions in debt & debt-oriented mutual funds.

2.4.5 Dividend Distribution Tax

Dividend distribution tax is not payable on dividends distributed by equity mutual fund schemes because the companies in which the mutual fund invests in, is liable to pay dividend distribution tax. Dividend distribution tax on debt mutual fund scheme is 25% +
surcharge + cess for individuals and Hindu undivided families and 30% + surcharge + cess for other taxable entities.

2.4.6 Dividend & Bonus Stripping

If an investor buys units within three months prior to record date of dividend and sells those units within nine months of record date, then the capital loss if any shall be reduced by the amount of dividends received.

In case an investor buys units within three months prior to record date of bonus and sells those units within nine months of record date, then the capital loss if any shall be ignored on the original units. The amount of short term capital loss would be assumed to be the cost of acquisition of the bonus units. The cost of acquisition of bonus units is usually nil but in this case the short term capital loss would be the cost of acquisition of the bonus units.

2.4.7 Set Off of Gains & Losses

Capital loss, short term or long term, cannot be set off against any other head of income other than Capital Gains. Short term capital loss is to be set off against short term capital gain or long term capital gain. Long term capital loss can only be set off against long term capital gain only. Since long term capital gains arising out of equity-oriented mutual fund units is exempt from tax, long term capital loss arising out of such transactions is not available for set off.

2.5 Comparative Analysis of Mutual Fund with Other Investments

2.5.1 Mutual Fund Vis-à-vis Bank/ Post Office Deposits

When an investor deposits money with the bank/ post office, the bank/ post office promises to pay the lender a certain rate of interest for the period he/ she specify. On the date of maturity, the bank/ post office is supposed to return the principal amount and interest to the lender. Whereas, in a mutual fund, the fund manager invests the money as
per the investment strategy specified for the scheme. The profit, if any, minus manager expense, is reflected in the net asset value or distributed as income. Similarly, loss, if any, with the expenses, is to be borne by the investor. Compared with a mutual fund scheme, a bank/post office deposit usually has the following drawbacks:

- Premature withdrawal is chargeable; so deposits with bank/post office suffer lack of liquidity.
- Returns from bank/post office deposits are taxable.
- Returns from bank/post office are not essentially attractive since they provide debt based returns which at most of the times fail to counter inflation only.

An investment in debt scheme is preferred over deposit schemes (of banks/post offices) on account of flexibility, liquidity, and applicable tax norms, possibility of higher returns etc.

2.5.2 Mutual Fund Vis-à-vis Public Provident Funds

The public provident fund is a fifteen (15) year product that is a risk-free government obligation and is open only to individuals and Hindu undivided families. Compared with a mutual fund scheme, a public provident fund usually has the following drawbacks:

- Only one public provident fund account can be maintained per entity
- Annual contribution is limited up to ₹ 1,00,000 (min ₹ 500) only
- Restriction on withdrawal reduces liquidity.

2.5.3 Mutual Fund Vis-à-vis Portfolio Management Scheme

In mutual funds, the investor’s money along with many others is pooled to form a common investible corpus. Any profit/loss made during a given period will be the same for all investors. However, if one chooses a portfolio management scheme, the individual investment remains identifiable to the investor. Thus, even the profit/loss of all the investors will be different from each other. Compared with a mutual fund scheme, a portfolio management scheme usually has the following drawbacks.
• The initial investment required in a portfolio management scheme is much higher. Portfolio management scheme being a big ticket product is thus accessible only by wealthy investors and not by retail investors.

• The investments in the portfolio management scheme are exposed to the risk of fiduciary threats as the company offering this service are not constituted in the form of a trust.

2.5.4  **Mutual Fund Vis-à-vis Real Estate**

Land/real estate are tangible assets while mutual fund is an intangible asset. Investor’s money in physical asset does not benefit economy. Moreover fire, flood and other natural calamities can affect physical assets which necessitates maintain of insurance of these assets. Compared with a mutual fund scheme, an investment in the real estate usually has the following drawbacks.

• The ticket size i.e. the minimum amount required for investing in real estate is high.

• Investors would find it difficult to maintain a diverse portfolio of real estate because of huge investment.

• Once purchased, vacant land can be encroached upon by others.

• The transaction costs, such as stamp duty and registration charges, are also high.

• Investments in real estate are highly illiquid.

Investment in financial real estate like real estate mutual funds makes more sense over physical investments on account of greater flexibility, liquidity & professional management.

2.5.5  **Mutual Fund Vis-à-vis Gold**

An investor can take exposure to gold in many ways. It can be by investing in physical gold in the form of coins, bars etc. Alternatively it can be by way of financial security
(linked to gold or with gold as the underlying) like gold exchange traded fund, gold futures contract, gold deposit schemes, gold sector fund (equity scheme) etc. Financial Gold investments have multiple benefits over Physical Gold investments:

- Physical gold suffers the risk of loss or theft.
- There exists tax advantage on financial gold assets; returns from investments in physical gold will be considered as long term gain in case the investment is beyond 36 months. However returns from investments in financial securities (where the underlying is physical gold) will be considered as long term gain in case the investment is only beyond 12 months.
- Wealth Tax is applicable on physical gold investments only.
- Nomination facility is available for financial gold investments.

2.6 INVESTMENT STRATEGIES IN MUTUAL FUNDS

2.6.1 Systematic Investment Plan

The systematic investment plan gives the investor the option of investing a fixed amount of money at fixed intervals over a period of time. The investor is allotted units on the basis of the amount invested and the prevailing net asset value on the predetermined dates. In other words, systematic investment plan is a method of investing a fixed/regular sum every month or every quarter. Refer to Tables 2.6.1.1 & 2.6.1.2 for a detailed illustration on how does systematic investment plans score better over lumpsum investment plans.

2.6.2 Systematic Withdrawal Plan

As opposed to the systematic investment plan, the systematic encashment plan (in other words, the systematic withdrawal plan) allows the investor the facility to withdraw predetermined amount/ units from his/ her holdings at a pre-determined interval. The investor's units will be redeemed at the applicable net asset value as on that day. In other words, the act of withdrawing a fixed amount of money from an investment pool at a
regular, fixed interval is known as systematic withdrawal plan. Systematic withdrawal plan is not a new phenomenon. Like systematic investment plan, systematic withdrawal plan is also a well known and widely propagated investment strategy by the investment community.

2.6.3 **Systematic Transfer Plan**

With a systematic transfer plan, one chooses a particular amount to be transferred from one mutual fund scheme to another of his/ her choice. One can go for a weekly, monthly or a quarterly transfer plan, depending on the needs. If one is looking at gradually exposing himself/ herself to equities or reducing exposure over a period of time, then this is a good option.

2.6.4 **Investment Parameters**

Income, expenses, commitments, financial goals and many other factors vary from person to person. Hence before investing ones money in mutual fund schemes, the following aspects needs to be analysed in details:

- **Investment objective.** The first step should be to evaluate ones financial needs. It can start by defining the investment objectives like regular income, buying a home, finance a wedding, educating your children, or a combination of all these needs. Investment should be made in such a mutual fund scheme where the stated investment objective matched with that of the investor.

- **Fund performance.** A good mutual fund scheme should be consistently able to deliver above average returns. In order to understand to what extent the same has been done by a particular mutual fund scheme, one should study the net asset value performance over the last few years in relation to appropriate yardsticks and other funds in the same category.
• **Costs.** The cost of investing through a mutual fund warrants due consideration since management fees, annual expenses of the fund and sales loads can erode a significant portion of the returns. Generally, 1% towards management fees and 0.6% towards other annual expenses is acceptable.

• **Other factors.** Other factors which become important in terms of selection of schemes are services offered by the mutual fund, the extent of investor friendliness, the level of transparency indicated in the quality and frequency of communications by the mutual fund etc.

Note. It is always advisable to diversify one's money by investing it in different schemes. This not only cuts down on the risk, but also gives the investor a chance to benefit from multiple industries and sectors.

### 2.6.5 Fund Selection

Mutual fund should be a core product as it is a vehicle that helps to take exposure in various asset classes like equity, debt, gold, real estate etc.

While investing in equity funds, a principle to internalize is that markets are more predictable in the long term, than in the short term. So, it is better to consider equity funds, only when the investment horizon is adequately long. During economic recession it is advisable to stick to large cap funds. At the end of recession/economic boom, a mid/small cap fund may be a good investment choice. Investments in value funds yield benefits over longer holding periods. In a market correction, the growth funds can decline much more than value funds.

Investors, who do not wish to take any equity exposure, should opt for a regular debt fund and not a monthly income plan ideally. Fixed maturity plans are better alternative to fixed deposits. Returns are mostly predictable for a specific period. However liquidity is less. A diversified debt fund can generate higher yield than gilt funds, but suffers from credit risk.
Longer term debt securities are more interest-rate sensitive, hence more volatile. Therefore, long term debt funds would be sensible in declining interest rate scenarios. However, if it is expected that interest rates in the market would go up, it would be safer to go with short term debt funds.

Liquid schemes are comparable with savings bank accounts. Switching some of the savings bank deposits into liquid schemes can improve the returns for investor. Businesses, which in any case do not earn a return on their current account, can transfer some of the surpluses to liquid schemes. ‘Liquid plus’ schemes include some longer tenure securities to generate higher return. Hence they are more like short-term debt funds than liquid funds.

In order to prevent potential mis-selling, SEBI has now disallowed the use of the term ‘liquid plus’ as a fund type.

Net asset value of floating rate funds is less volatile than other debt funds. When the interest rate scenario is unclear, then floaters are a safer option. An investor desirous of having a mix of debt and equity exposures can simply invest in a balanced fund. Balanced schemes may be taxed as a debt scheme or an equity scheme depending on the scheme’s investment portfolio (65% exposure).

Investors need to differentiate between Gold ETF and gold sector funds. Out of these two, gold ETFs move in line with the price of gold.
OUTCOMES OF THIS CHAPTER

The research work undertaken, as elaborated in this chapter, had helped in establishing the following understandings:

- **Open ended mutual fund schemes.** Investors can buy and sell units, at any time, directly from the asset management company. The unit capital is variable.

- **Close ended mutual fund schemes.** Open for sale to investors for a specified period (NFO) after which further sales are closed. Any further transactions happen in the secondary market where closed-ended funds are usually listed.

- **Actively managed mutual fund schemes.** The fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective for generating returns higher than the officially stated benchmark.

- **Passively managed mutual fund schemes.** The fund manager tends to mimic the market index and generate returns accordingly.

- The different types of asset classes in which mutual fund schemes invest are **Equity** (Large, Mid & Small Cap and Index), **Debt** (Sovereign Bonds and Corporate Debentures), **Gold**, **Commodities**, **Real Estate** and other Mutual Fund Schemes.

- An investment in debt scheme is preferred over deposit schemes (of banks/ post offices) on account of flexibility, liquidity, taxability and possibility of higher returns. Compared with a mutual fund scheme, a portfolio management scheme has the drawbacks of high initial investment and risk of fiduciary threat. Compared with a mutual fund scheme, an investment in the real estate has the drawbacks of high ticket size, limits to diversification, physical encroachment, high transaction cost and lack of liquidity. Finally, financial Gold investments have multiple benefits over physical Gold investments like no risk of loss or theft and tax advantage.