CHAPTER - 5

PROSPECTS OF MUTUAL FUND
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Future of Mutual funds industry seems to be bright in view of improved performance of fund managers and increasing confidence of investors in working of the funds and also benefits of investing in funds. Further, with economy picking up, mutual fund industry is expected to grow at a good pace. It is also expected that money moving into the lap of mutual funds from banks as open ended funds offer same convenience, higher rate of returns, variety of schemes, better performance, transparency, after sales customer service and genuine retail investor interest will drive the industry growth. Technology and new distribution channels would increase as investors move funds from traditional investment channels.

The chairman of Housing Development Finance Corporation Deepak Parekh rightly stated "we have only scratched the surface". Prospects of Mutual Funds Industry are likely to brighten further in view of some important reforms. With the SEBI proposing a corporate structure on the lines of US funds, the existing trustee structure will be modified to introduce professional trustee companies. The underlying objective is to bring greater democracy in mutual fund administration and give the unit holders the right to change the trustees if they fail to perform their jobs. More flexibility to Asset Management Companies (AMCs) is also likely so that it can charge expenses which are directly attributable to a particular scheme. Investors will have access to the balance sheets of AMCs. Although the balance sheets of AMCs
which are subsidiaries of public listed companies are already available. But most foreign mutual funds are not bound to disclose their AMC operations separately and this provision would help investors understand their operations better. The role of SEBI could come in when a fund desire to limit the size of its assets when it has grown over a period of time due to inflow of funds and increase in stock prices. Relatively low penetration levels combined with rapid growth in the asset under management in recent years point to the high growth potential of the Indian Mutual Fund Industry.

Going forward the Indian Mutual Fund industry is expected to secure growth by catering to the evolving aspirations of retail customers. The industry seeks to target an increasing share of the customer wallet through product innovation combined with deeper retail penetration by expanding reach into Tier 2 and Tier 3 towns. The industry will need to include capital safety features in product design, build strong brands that are hallmarks of financial integrity, service orientation and sustained fund performance. Building investors trust and increase customer awareness through imitative aimed at promoting financial literacy will be critical factors towards building greater retail participation.

KPMG in India is of the view that the industry Asset Under Management (AUM) is likely to continue to grow the range of 15 to 25 percent from the period 2010 to 2015 based on the pace of economic growth. In the event of a quick economic revival and positive reinforcement of growth drivers identified, KPMG in India is the view that the India Mutual Fund Industry may grow at the rate of 22 to 25 percent in the period from 2010 to
2015, resulting in AUM of ₹ 16,000-18,000 billion in 2015. In the event of a relatively slower economic revival resulting in the identified growth drivers not reaching their full Potential, KPMG in India is of the view the Indian Mutual Fund Industry may grow in the range of 15 to 18 percent in the period 2010 to 2015, resulting in AUM of ₹ 15,000 to ₹ 17,000 billion in 2015. Industry profitability may reduce further as revenues shrink and operating cost escalate. Product Innovation is expected to be limited. Market deepening and widening is expected with the widening is expected with the objective of increased retail penetration and participation.

5.1 MULTIPLE REGULATORY FRAMEWORKS GOVERNING FINANCIAL SERVICES SECTORS

The regulatory and compliance requirements vary across verticals within the financial services sector specifically mutual funds, insurance and pension funds each of which are governed by a independent regulatory framework and are competing for the same share of the customer's wallet. The mutual fund industry lacks a level playing field in comparison with other verticals within the financial services sectors. The mandatory PAN card requirement for investing in mutual funds is perceived to restrict significant potential of the mutual fund industry in being able to tap small ticket investors from investing in mutual funds.

On the other hand, ULIPs which are deemed to be competing products do not have the mandatory PAN requirement. While the payment for investment into mutual funds can be made only through banking facilities, the
purchase the ULIPs can be undertaken through cash. The recently introduced NPS regulations requiring the AMCs to create a separate legal entity for pension funds management have created an additional cost structure for the mutual fund players.

Outsourcing funds management in excess of ₹ 80 billion by insurance companies is not permitted and thus restricts an additional revenue opportunity for the mutual fund industry. In summary, the challenges and issues faced by the Indian mutual fund industry will need to be addressed at the earliest to ensure long term sustained profitable growth of the industry. The Reserve Bank of India (RBI) has sounded caution on bank's growing involvement in mutual funds as there are issues concerning systemic stability.

Investors will hopefully be able to know their distributors better, as the Association of Mutual Funds in India (AMFI) plans to unveil Know-Your-Distributor to (KYD) norms for mutual fund distributors. These norms will be applicable to all who desire to engage in mutual fund distribution and ARN (AMFI Registration Number) holder. In order to enforce discipline and check front running activity in mutual funds houses, the Securities and Exchange Board of India (SEBI) has asked fund houses to install conversation recording facilities in dealing rooms and also disallow dealers from using personal mobile phones in the dealing rooms. Moreover, SEBI has also asked mutual fund houses to maintain records of the phone conversations in the dealing room for at least eight years, which will be open for SEBI inspection and will also be periodically checked by the designated executives of the fund house and reports will be
submitted to the trustees of the fund house. SEBI directed mutual fund houses to have a uniform exit load for investment through lump sum as well as the SIP (Systematic Investment Plan) route. Presently, mutual fund houses levy an exit load of 1% in case of investment redeemed before a year.

In a move to help mutual fund investors, SEBI brought in the next round of changes by proposing that mutual fund houses should mandatory benchmark the performance of their equity oriented schemes, ‘primarily’ with one of the two most widely accepted indices i.e. BSE Sensex or Nifty, along with the index chosen for the particular fund [as mentioned in the Scheme Information Document (SID)].

Global events do cast their shadow on capital markets in India also. The stock indicates dance to the tune of NASDAQ movement in USA. International events like terrorists attack in New York or outbreak of war in Afghanistan or Iraq do dampen the spirit of Indian investors. Media sensitive Indian investor will create selling pressure in stock markets even on petroleum minister's expression in media to increase diesel prices without waiting to see when the proposal gets mature. Tech savvy Indian stock markets immediately reflect any bad news, thus, further weakening the overall market sentiments. As a mutual fund invests its pooled money in capital markets which in turn depends upon economic growth of a country, thus, in this turbulent environment, the question to be answered is: What prospects do mutual fund industry has in India?
Hence, the aspects of country's economic health and its future, effective management by professional fund managers and government regulation of funds have an important role to play in deciding the fate of mutual fund in India.

After SEBI's approval in June, 2000 the derivative trading in Indian capital markets has been introduced. First instruments to be traded were index futures. Later on options and futures were also added to the trading list. Since Jan 2000, after its introduction, internet trading has also shown a tremendous growth in the Indian Capital market operations. Table 5.1, highlights the reforms of the securities market in India during the period 1992 to 2012.

The table 5.1 highlights the changed scenario of Indian securities market as it is today over what it was in 1992, i.e. during the initial years of implementation of LPG policy in India. To improve market efficiency, enhance transparency, prevent unfair trade practices and to bring the Indian market up to international standards has been the main focus of reforms throughout these years. The increase in the inflow of foreign investments in the Indian capital market, confirms the acceptance of the progress shown.
Table 5.1

<table>
<thead>
<tr>
<th>Feature</th>
<th>1992</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulator</td>
<td>No specific regulator, but central government oversight</td>
<td>A specialized regulator for securities market (SEBI) vested with powers to protect investor's interest and to develop and regulate securities market. SROs strengthened</td>
</tr>
<tr>
<td>Securities</td>
<td>Limited number of traditional instruments</td>
<td>Expanded to cover government securities, units of CISs and MFs, derivatives of securities, security receipts, etc.</td>
</tr>
<tr>
<td>Form of Securities</td>
<td>Physical</td>
<td>Dematerialized</td>
</tr>
<tr>
<td>Regulatory Approach</td>
<td>Merit-based regulation</td>
<td>Desclosure based regulation</td>
</tr>
<tr>
<td>Intermediaries</td>
<td>Some of the intermediaries (Stock broker, authorized clerks and remises regulated by SROs)</td>
<td>A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by SROs). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances. All participants are identified by a unique identification number.</td>
</tr>
<tr>
<td>Access to market</td>
<td>Granted by central government</td>
<td>Eligible issuers access the market after complying with issue requirements</td>
</tr>
<tr>
<td>Disclosure</td>
<td>Voluntary, vague, scanty and non-standardized</td>
<td>Standardized, systematic and at par with international standards. A dedicated website for corporate disclosures</td>
</tr>
<tr>
<td>Pricing of securities</td>
<td>Determined by central government</td>
<td>Determined by market either by the issue through fixed price or by the investors through book building</td>
</tr>
<tr>
<td>-----------------------</td>
<td>---------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Access to international market</td>
<td>No access</td>
<td>Corporate allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two way fungibility. FIIIs allowed trade in Indian market. MFs also allowed to invest overseas</td>
</tr>
<tr>
<td>Corporate compliance</td>
<td>Very little emphasis</td>
<td>Emphasis on disclosures. Accounting Standards and corporate governance</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>Restricted to public sector</td>
<td>Open to private sector and emergence of a variety of funds and schemes</td>
</tr>
<tr>
<td>Trading mechanism</td>
<td>Open outcry, available at the trading rings of the exchanges, opaque, auction/ negotiated deals</td>
<td>Screen-based trading system. Orders are matched on price-time priority. Transparent trading platform accessible from all over country.</td>
</tr>
<tr>
<td>Aggregation of order flow</td>
<td>Fragmented market through geographical distance. Order flow unobserved</td>
<td>Order flow observed. The exchanges have open electronic consolidated limit order book (OECLOB)</td>
</tr>
<tr>
<td>Anonymity in trading</td>
<td>Absent</td>
<td>Complete</td>
</tr>
<tr>
<td>Settlement cycle</td>
<td>14 day account period settlement, not adhered to always</td>
<td>Rolling settlement on T+2 basis</td>
</tr>
<tr>
<td>Counterparty risk</td>
<td>Present</td>
<td>Absent</td>
</tr>
<tr>
<td>Form of settlement</td>
<td>Physical</td>
<td>Mostly electronic</td>
</tr>
<tr>
<td>Basis of settlement</td>
<td>Bilateral Netting</td>
<td>Multilateral Netting</td>
</tr>
<tr>
<td>Transfer of securities</td>
<td>Cumbersome, transfer by endorsement on security and registration by issuer</td>
<td>Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories</td>
</tr>
<tr>
<td>Risk management</td>
<td>No focus on risk management</td>
<td>Comprehensive risk management system encompassing capital adequacy. Limits on exposure and turnover, VaR-based margining, client level gross margining, online position monitoring, etc.</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Derivatives trading</td>
<td>Absent</td>
<td>A wide array of exchange traded derivatives such as futures and options on indices and select securities and futures on interest rate available</td>
</tr>
<tr>
<td>Research</td>
<td>Very Little</td>
<td>Many market participants have full fledged research department. Some of them have schemes/initiatives to promote research</td>
</tr>
<tr>
<td>Government Securities</td>
<td>Market outcomes such as quantity and price exogenously determined</td>
<td>Issue at market related rates, product bouquet windened, negotiated Dealing System Operationalised, Retail trading permitted on exchanges, DVP introduced for settlement of transaction, Clearing Corporation for central counter party.</td>
</tr>
</tbody>
</table>

**Source:** SEBI Bulletins

### 5.2 REGULATION, GUIDELINES AND SCHEMES ISSUED BY SEBI:

**Regulations**

1. SEBI (Stock Brokers and Sub-Brokers), Regulations, 1992
2. SEBI (Prohibition of Insider Trading), Regulations, 1992
3. SEBI (Merchant Bankers) Regulation, 1998
4. SEBI (Portfolio Managers) Regulations, 1998
5. SEBI (Registrar to An Issue and Share Transfer Agents) Regulations, 1999
6. SEBI (Underwriters) Regulations, 1999
7. SEBI (Debenture Trustees) Regulations, 1999
8. SEBI (Bankers to an issue) Regulations, 2000
9. SEBI (Foreign Institutional Investors) Regulations, 2001
10. SEBI (Custodian of Securities) Regulations, 2002
11. SEBI (Depositories and Participants) Regulations, 2002
12. SEBI (Venture Capital Funds) Regulations, 2002
13. SEBI (Mutual Funds) Regulations, 2003
14. SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2004
15. SEBI (Buy-Back of Securities) Regulations, 2005
16. SEBI (Credit Rating Agencies) Regulations, 2006
17. SEBI (Collective Investment Schemes) Regulations, 2006
18. SEBI (Foreign Venture Capital Investors) Regulations, 2007
19. SEBI (Procedure for Board Meeting), Regulations, 2005
20. SEBI (Issue of Sweat Equity) Regulations, 2010
21. SEBI (Procedure for Holding Enquiry by Enquiry Officer and imposing Penalty) Regulations, 2010
23. SEBI (Central Listing Authority) Regulation, 2011
24. SEBI (Ombudsman) Regulation, 2011
25. SEBI (Central Database of Market Participants) Regulations, 2011
26. SEBI (Self Regulatory Organizations) Regulations, 2011
27. SEBI (Criteria for Fit and Proper Person) Regulation, 2010

Guidelines

1. SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Regulation, 2000
2. SEBI (Guidelines for Opening of Trading Abroad) Issued in 2001
3. SEBI (Disclosure and Investor Protection), Guidelines, 2002
4. SEBI (Delisting of Securities) Guidelines, 2005
5. SEBI (STP Centralized Hub and STP Service Providers) Guidelines, 2006

Schemes

1. Securities Lending Scheme, 2000
2. SEBI (Informal Guidance) Scheme, 2004

Initiative

Mutual fund industry, as it is a part and parcel of the economy will be moving with the movement in the Indian economy. This clearly brings out the importance of this investment channel in the Indian economy. Noticeably, at times when share index had not been doing well, even then, mutual funds maintained their overall position in the Indian capital market. But after the private sector mutual funds were allowed to enter the Indian market assets under fund management grew to ₹ 61301.21 crores in 1993-94 and touched the figure of ₹ 107946.10 crores by 2005-06. After falling back to ₹ 90586.87 crores in 2000-01 it has again risen to ₹ 149600.41 crores by the end of March 2010.

5.3 GOVERNMENT REGULATION OF MUTUAL FUNDS AND THEIR PROSPECTS:

On the other hand, after being bitten by capital market scams that emerged due to stock market irregularities, SEBI has been trying hard to control the markets. In this regard, continuous monitoring of markets and its players is done by the SEBI. It has also been issuing different circulars, notifications and guidelines for efficient and transparent working of stock markets. (See Table; 5.2)

As unprecedented growth has been registered by mutual funds in resource mobilization in the Indian market, SEBI has been trying hard to regulate their working. SEBI, from time to time has been issuing different circulars specifically for smooth and regulated working of this industry. The Table 5.2 gives birds eye view of various circulars issued by SEBI since 1999 onwards.
Table 5.2

Important Circulars issued by SEBI in India related to Mutual Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Important circular</th>
</tr>
</thead>
</table>
| 2003 | • Guidelines for participation by Mutual Funds in stock lending schemes  
       • Investment in ADRs/GORs, by Mutual Funds  
       • Reporting of transactions by Mutual Funds |
| 2004 | • AMFI recommendations for improving Disclosures and Compliance Standards  
       • Frequency of Portfolio Disclosure. Formation of Audit and Valuation Committee  
       • Guidelines for participation by Mutual Funds in Trading in Derivation Products  
       • Payment of interest or delay in dispatch of redemption or repurchase proceeds  
       • Guidelines for advertisement by Mutual Funds  
       • Recording of Investment decisions by Mutual Funds |
| 2005 | • Guidelines for updating of offer document, time frame for dispatch of dividend warrants and reporting of securities transactions by Directors of AMCs on Quarterly basis  
       • Investment/Trading in Securities by Employees of Asset Management Companies  
       • Putting Standard Observation on Website |
<table>
<thead>
<tr>
<th>Year</th>
<th>New Regulations</th>
</tr>
</thead>
</table>
| 2006 | • Clients codes for Mutual Funds  
       • Gazette Notification, Investments by Mutual Funds in Venture Capital Funds  
       • Independent Direction on Boards of AMCs and Trustee Companies.  
       • Guidelines for Participation by Mutual Funds in Trading in Derivative Products  
       • Registration of Intermediaries  
       • Portfolio Disclosures  
       • Calculation of sale and repurchase prices of units of Mutual Fund Scheme  
       • Introduction of Benchmarks |
| 2007 | • Guidelines for Investments in Foreign Securities by Mutual Funds  
       • Investment limits for government guaranteed debt securities  
       • Minimum Number of Investors in Schemes/Plans of Mutual Funds |
| 2008 | • Uniform cut-off-timings for applicability of Net Asset Value (NAV) of mutual funds  
       • Investment in foreign securities by mutual funds  
       • Mentioning of bank account number and PAN by the investors  
       • Guidelines for participation by mutual funds in Derivative trading  
       • Unique client code for schemes/plans of mutual funds |
The above-mentioned circulars and notifications show the back of the mind of this autonomous body. Though lately, it seems that SEBI has realized its responsibility of a watchdog for hard earnings of small Indian Investors.

Another important aspect to be considered for assessing mutual fund industry's prospects in India is the role to be played by professional fund managers who can help sustain and grow mutual fund industry in the coming times. World over, including in India, drastic changes have occurred in the capital markets as regards information disclosures, reduced transaction costs and dematerialization of securities, specifically, leading to odd lot trading. This has resulted in a situation where individual investor with small investment can buy adequate number of securities of different companies and can build diversified portfolio of his choice (the function provided by mutual funds). Furthermore, dematerialization of securities lead to trading in odd lots, i.e. shares can be traded in fractions also. Shares of almost all companies are in demat form thus leading to reduced costs, too. Moreover any active investor can time the market because of information abundance and accuracy today. The chances of mispricing of securities in such type of market are remote. Therefore, information availability for small investor is similar as for any fund manager. Thus, the survival of mutual funds and need for professional fund managers could be questioned. This could be answered briefly as:

1. All of the investors are not properly educated to understand the intricacies of financial figures published by different companies.
2. All shares have been covered under rolling settlements now thus making it difficult for a small investor to settle the account at every day end.

3. Flourishing mutual fund business hints at the small investor’s belief in expertise of professional fund managers.

In tricky situations of falling markets all rests upon fund managers market timing ability that how quickly the manager encash the equity investments and transfer the money to cash securities temporarily? This is not possible for a small investor. Good returns from equity-oriented mutual funds schemes in rising markets have always catching the fancy of investors. The rate cut on deposits and different government securities announced by the government has been pushing the investors for investment in equities or plans of mutual funds. Thus the trend has again been set for investment going out of debt instruments back to equity markets. The analysts, however, recommend that investors will minimum investible funds of ₹ 4-5 lacs should enter equity stock investment at this juncture, which is not possible for majority of small investors. Hence, only way out for them will be to enter enroute mutual funds. Therefore, professional of managers have to shoulder the responsibility of safe investment on behalf of small investors.

5.4 PROSPECTS:

From the foregoing five major aspects that would be helpful in assessing the future prospects of mutual funds in India are listed as:

1. Investors responses to the survey
2. Performance evaluation of certain selected mutual funds

3. Economic growth parameters

4. Government regulation of mutual funds, and

5. Role of professional fund managers.

In nutshell, compiling these one by one precisely, it could be said that:

1. Though half of the existing investors in the survey have decided to opt out of the mutual funds, other half still wants to continue with their investments in mutual funds. Also, about 20% of investors surveyed fall in the category of new interested for making fresh investment in mutual funds. No doubt, the experience as regards returns on investment from mutual funds of majority of investors has been shaky, but the role of SEBI and the management of the funds by professional managers, too, have been equally criticized. Overall, responses of the investors have been mixed. Though lately, these agencies have started realizing their responsibility as regards management of security market.

2. Performance evaluation of only five most preferred mutual funds conducted here reveals as on one hand UTI and Templeton India fund have under performed but on the other, funds namely, Alliance Capital India, Prudethal ICICI and Pioneer ITJ have posted reasonably good performance, too. Further, fact that last few years have been quiet turbulent for the capital markets all over
the world, including India cannot be ignored. Also, the fund managers cannot escape the responsibility of poor fund management. On the whole, performance of mutual funds, too, has been mixed.

3. As already discussed in this chapter, the growth potential of an Indian economy cannot be denied. Cyclic movements, however, could not be ruled out. Hence, growth pattern of different economic sectors looks positive, therefore, mutual funds industry is also expected to gain.

4. SEBI and other controlling bodies of capital markets have started monitoring the market movements more closely. A consistent effort is being made by them to refine the working of capital markets and mutual funds. This is expected to go a long way in reviving the lost confidence of small investors in mutual funds.

5. Last but not the least, the managers of these mutual funds need to sharpen their skills further so to manage the pooled money in a total professional way. Market timing, during both the bull and the bear run is the sole factor that should ensure their long-term survival in the trade.

In nutshell, it could be said that mutual funds invest their funds in stock markets, which in turn depends upon the economic performance and political stability of that economy (which largely in case of India, depends upon
stability of oil prices in the international market) on one hand and fund’s professional management on the other. Hence, with flourishing business of mutual funds in India, conducive environment for capital markets expected to be provided by the governments and positive initiatives being taken by SEBI to streamline mutual funds business, all now rests upon the professional fund managers that how they sharpen their market timing skills and diversify product range so to make funds tailor made to the needs of every investor to provide handsome returns to them who entrust their hard earned money to the fund managers.