Chapter - I
INTRODUCTION

Ever since India embarked on the policy of democratic socialism, public sector has played a vital role in the economic development of the country. The industrial policy resolution was introduced by the government in the year 1948 immediately after the independence which has outlined the approach to industrial growth and development. The industrial policy statement of 1980 focused to promote competition in the domestic market, upgrade the existing technology and modernize the system as a whole. A number of policies and procedural changes introduced in the years 1985 and 1986 aimed at increased productivity, reduced costs, improved quality and encouraged the public sector industries. Overall, in the seventh plan period (1985-86 to 1989-90) Indian industries witnessed an impressive average annual growth rate of 8.5 per cent. The past decades have seen a phenomenal expansion in the geographical coverage and financial spread of the Indian financial system. The spread of the banking system had been a major factor in promoting financial intermediation in the economy and in the growth of financial savings. With progressive liberalization of economic policies, there has been a rapid growth of capital market, money market and financial services industry. Reforms initiated in the financial sector have paved the way for the entry of wide range of financial services. As a result, a large number of financial institutions, instruments, markets and services have come up to promote the economic development and to encourage the savings through the organized sector. Consistent with evolution and development of the financial sector, the mutual fund
industry occupied an important place as the mobilized assets are invested on behalf of the investors. In this connection, the chapter aims at introducing the theoretical and the practical aspects of mutual funds which are important to take pertinent decisions. As mutual funds are mostly preferred by the small investors, the knowledge of mutual funds helps the investor to pick the right kind of fund and manage the investments timely and professionally as per their objective and need. To present the overall picture of worldwide mutual fund industry, brief description of net assets of various countries is included. The performance of Indian mutual fund industry is presented through the net assets mobilized, the growth in the number of schemes like open ended, closed and interval schemes and also the Asset under management (AUM) and contribution of mutual funds to the gross domestic product (GDP). Some important performance measures are also covered which indicates the present status and prospects of the mutual funds.

1.1 Definition

According to Securities Exchange Board of India (SEBI) “Mutual Funds can be defined as “A fund established in the form of a trust to raise money through the sale of units to public or a section of public under one or more schemes for investing in securities, including money market instruments”.

1.2 Meaning of Mutual Fund

“A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal”. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them. Thus, a
Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

**Chart 1.1 Working of mutual fund**

1.3 Importance of Mutual Fund

Small investors face a lot of problems in the share market due to limited resources, lack of professional advice, lack of information etc. Mutual funds have come as a much needed help to these investors. It is a special type of institutional device or an investment vehicle through which the investors pool their savings which are to be invested under the guidance of a team of experts in a wide variety of portfolios of Corporate securities in such a way, so as to minimize risk, while ensuring safety and steady return on investment. It forms an important part of the capital market providing the benefits of a diversified portfolio and expert fund management to a large number, particularly to small investors. The mutual funds are gaining the popularity due to the following reasons:

- With the emphasis on increase in domestic savings and improvement in deployment of investment through markets, the need and scope for mutual fund operation has increased
tremendously. The basic purpose of reforms in the financial sector was to enhance the generation of domestic resources by reducing the dependence on outside funds. This calls for a market based institution which can tap the vast potential of domestic savings and channelize them for profitable investments. Mutual funds are not only best suited for the purpose but also capable of meeting this challenge.

- An ordinary investor who applies for share in a public issue of any company is not assured of any firm allotment. But the subscription by mutual funds to the capital issue made by companies get firm allotment of shares. Mutual fund latter sell these shares in the same market and to the Promoters of the company at a much higher price. Hence, mutual fund creates the investors’ confidence.

- As mutual funds are managed by professionals, they are considered to have a better knowledge of market behaviors. Besides, they bring a certain competence to their job. They also maximize gains by proper selection and timing of investment.

- Another important thing is that the dividends and capital gains are re-invested automatically in mutual funds and hence are not fritted away. The automatic reinvestment feature of a mutual fund is a form of forced saving and can make a big difference in the long run.

- The mutual fund operation provides a reasonable protection to investors. Besides, presently all Schemes of mutual funds provide tax relief under certain sections of the Income Tax Act and in addition, some schemes provide tax relief under
Section 88 of the Income Tax Act lead to the growth of importance of mutual fund in the minds of the investors.

- As mutual funds creates awareness among urban and rural middle class people about the benefits of investment in capital market, mutual fund could be able to make up a large amount of the surplus funds available with these people through profitable and safe avenues.

The mutual fund attracts foreign capital flow in the country and secure profitable investment avenues abroad for domestic savings through the opening of off shore funds in various foreign investors. Lastly another notable thing is that mutual funds are controlled and regulated by SEBI and hence are considered safe. Due to all these benefits the importance of mutual fund has been increasing.

1.4 Advantages of Mutual Funds

The following are some of the important advantages of mutual funds:

- **Portfolio Diversification** - Mutual Funds invest in a well-diversified portfolio of securities which enables investor to hold a diversified investment portfolio (whether the amount of investment is big or small).

- **Professional Management** - Fund manager undergoes through various research works and has better investment management skills which ensure higher returns to the investor than what the investors can manage on their own.

- **Less Risk** - Investors acquire a diversified portfolio of securities even with a small investment in a Mutual Fund. The risk in a diversified portfolio is lesser than investing in merely two or three securities.
- **Low Transaction Costs** - Due to the economies of scale (benefits of larger volumes), mutual funds pay lesser transaction costs and these benefits are passed on to the investors.

- **Liquidity** - An investor may not be able to sell some of the shares held by him very easily and quickly, whereas units of a mutual fund are far more liquid.

- **Choice of Schemes** - Mutual funds provide investors with various schemes with different investment objectives. Investors have the option of investing in a scheme having a correlation between its investment objectives and their own financial goals. These schemes further have different plans/options.

- **Transparency** - Funds provide investors with updated information pertaining to the markets and the schemes. All material facts are disclosed to investors as required by the regulator.

- **Flexibility** - Investors also benefit from the convenience and flexibility offered by Mutual Funds. Investors can switch their holdings from a debt scheme to an equity scheme and vice-versa. Option of systematic (at regular intervals) investment and withdrawal is also offered to the investors in most open-end schemes.

- **Safety** - Mutual Fund industry is part of a well-regulated investment environment where the interests of the investors are protected by the regulator. All funds are registered with SEBI and complete transparency is enforced.
1.5 Disadvantages of Mutual Funds

Mutual funds like any other investment options have certain disadvantages as presented below:

- **Costs Control Not in the Hands of an Investor** - Investor has to pay investment management fees and fund distribution costs as a per cent of the value of his investments (as long as he holds the units), irrespective of the performance of the fund.

- **No Customized Portfolios** - The portfolio of securities in which a fund invests is a decision taken by the fund manager. Investors have no right to interfere in the decision making process of a fund manager, which some investors find as a constraint in achieving their financial objectives.

- **Difficulty in Selecting a Suitable Fund Scheme** - Many investors find it difficult to select one option from the plethora of funds/schemes/plans available. For this, they may have to take advice from financial planners in order to invest in the right fund to achieve their objectives.

1.6 The Trend of Worldwide Mutual Funds

The brief data relating to net assets of worldwide mutual funds operating in various countries is shown in Table 1.1.

It is observed that the U.S. mutual funds occupied a major share in the world’s mutual fund industry followed by European funds. The world net assets of mutual funds have registered positive growth from 2002 to the year 2008. The Indian mutual fund industry occupied only 0.13 per cent of the worldwide net assets whereas Americas’ net assets were 63.78 per cent, Europe recorded 27.18 per cent and 8.78 by Asia and Pacific countries excluding India in the year 2001. Indian Mutual funds have recorded a slow growth rate till the year 2004. From this year there was huge inflow of funds into the industry. Large number of
Investment companies entered the market offering wide array of mutual funds with different investments options available to almost all segments of the investors since the year 2006. It is observed that the highest growth was recorded in the year 2005-06. Due to the global economic crisis the mutual funds have witnessed a decline trend in almost all the countries during the period 2009. Growth levels have stumbled in the year 2011 due to the high fluctuations in the stock markets. In the year 2011 the Indian mutual funds industry contributed about 3.06 per cent to the worldwide net assets. It is evident from the table 1.1 that the American and European mutual funds occupy a significant place in the worldwide net assets of mutual funds. The year witnessed tremendous redemptions and shift of investments from mutual funds to other investments like real estate, gold and bank deposits which are considered to be relatively safe than the investments on the stock exchanges. The impact of global economic crisis has shown decline trend, but still could recover with stringent investment regulations and conservative investment pattern suggested by SEBI and self regulatory authority, AMFI.

The Indian mutual fund industry is in a state of development and needs to have a severe push to increase the net assets. However, it is observed that the regulatory body SEBI is introducing investor friendly regulations to improve the mutual funds share in the capital markets. The macro-economic environment with high savings and investment rates is conducive for further development in the mutual funds industry. To channelise these increased savings into mutual fund products, the Asset Management Companies (AMCs) need to assure retail investors with a sufficient (inflation-adjusted) yield. AMCs shall focus on enhancing their investments in product development, customer relationship management and upgrade the customer-profile.
Table 1.1 Worldwide Net Assets of Mutual Funds

<table>
<thead>
<tr>
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<td>11324128</td>
<td>14048311</td>
<td>1616475</td>
<td>1777107</td>
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<td>2612954</td>
<td>1897451</td>
<td>22952806</td>
<td>24699170</td>
<td>23779874</td>
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<td></td>
<td>(-2.84)</td>
<td>(24.06)</td>
<td>(15.07)</td>
<td>(9.94)</td>
<td>(22.71)</td>
<td>(19.82)</td>
<td>(27.38)</td>
<td>(20.97)</td>
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<td>Americas</td>
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<td>6776289</td>
<td>7969541</td>
<td>8792450</td>
<td>9763921</td>
<td>1146906</td>
<td>1342114</td>
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<td>13,586,843</td>
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<td>Europe</td>
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<td>3462999</td>
<td>4682836</td>
<td>5640452</td>
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<td>8934864</td>
<td>6288138</td>
<td>11,120,153</td>
<td>11,820,650</td>
<td>11,621,595</td>
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<td>Asia and Pacific</td>
<td>1039236</td>
<td>1063857</td>
<td>1361473</td>
<td>1677887</td>
<td>1939251</td>
<td>2456511</td>
<td>3678330</td>
<td>2037536</td>
<td>729,141</td>
<td>854,413</td>
<td>816,537</td>
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<tr>
<td>India</td>
<td>15284</td>
<td>20364</td>
<td>29800</td>
<td>32846</td>
<td>40546</td>
<td>58219</td>
<td>108582</td>
<td>62805</td>
<td>130,284</td>
<td>111,421</td>
<td>87,519</td>
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<td></td>
<td>(33.24)</td>
<td>(46.34)</td>
<td>(10.22)</td>
<td>(23.44)</td>
<td>(43.59)</td>
<td>(86.51)</td>
<td>(-46.21)</td>
<td>(107.44)</td>
<td>(-14.48)</td>
<td>(-21.45)</td>
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<tr>
<td>Africa</td>
<td>14561</td>
<td>20983</td>
<td>34460</td>
<td>54006</td>
<td>65594</td>
<td>78026</td>
<td>95221</td>
<td>69417</td>
<td>106,261</td>
<td>141,615</td>
<td>124,976</td>
</tr>
</tbody>
</table>

*Source: ici.org*
1.7 Evolution of mutual funds in India

The foreign and colonial government Trust of London of 1868 is considered to be the fore-runner of the modern concept of mutual funds. The USA is, however, considered to be the Mecca of modern mutual funds. By the early - 1930s quite a large number of close - ended mutual funds were in operation in the U.S.A. Much later in 1954, the committee on finance for the private sector recommended mobilization of savings of the middle class investors through unit trusts. Finally in July 1964, the concept took root in India when Unit Trust of India (UTI) was set up with the twin objective of mobilizing household savings and investing the funds in the capital market for industrial growth. Household sector accounted for about 80 per cent of nation’s savings and only about one third of such savings was available to the corporate sector, it was felt that UTI could be an effective vehicle for channelizing progressively larger shares of household savings to productive investments in the corporate sector.

1.8 Growth of Mutual funds in India

The process of economic liberalization in the eighties not only brought in dramatic changes in the environment for Indian industries, Corporate sector and the capital market but also led to the emergence of demand for newer financial services such as issue management, corporate counseling, capital restructuring and loan syndication.

The Mutual Fund Industry started with UTI set up under an Act of Parliament in 1963. In 1987 the Mutual Fund Industry was opened to other Public Sector Banks & Financial Institutions and immediately seven such Funds commenced. In 1993 SEBI Mutual Fund Regulations notified. In
1993 Private Sector players were permitted to enter the Mutual Fund Industry. In 2003 the UTI Act was repealed, it marked the end of Assured Returns Schemes; ‘UTI Mutual Fund’ came into being. The formation of UTI marked the evolution of the Indian mutual fund industry in the year 1963. The primary objective at that time was to attract the small investors and it was made possible through the collective efforts of the Government of India and the Reserve Bank of India (RBI). The history of mutual fund industry in India can be better understood divided into following phases:

1.8.1 Phase I - Establishment and Growth of UTI - 1964-87

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

UTI launched more innovative schemes in 1970s and 80s to suit the needs of different investors. It launched Unit Linked Insurance Plan (ULIP) in 1971, six more schemes between the years 1981-84, Children's Gift Growth Fund and India Fund (India's first offshore fund) in 1986, Master share (India’s first equity diversified scheme) in 1987 and Monthly Income Schemes (offering assured returns) during 1990s. By the end of 1987, UTI's AUM grew ten times to Rs 6,700 crores.
1.8.2 Phase II - Entry of Public Sector Funds - 1987-1993

The Indian mutual fund industry witnessed a number of public sector players entering the market in the year 1987. In November 1987, ‘SBI Mutual Fund’ from the State Bank of India became the first non-UTI mutual fund in India. SBI Mutual Fund was later followed by ‘Can bank Mutual Fund’, ‘LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund’. By 1993, the AUM of the industry increased seven times to Rs. 47,004 crores. However, UTI remained to be the leader with about 80 per cent market share as depicted in the table 1.2.

Table 1.2: Entry of Public Sector Funds - 1987-1993

<table>
<thead>
<tr>
<th></th>
<th>Amount Mobilized</th>
<th>AUM</th>
<th>Mobilization - gross Domestic Savings(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-93</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UTI</td>
<td>11,057</td>
<td>38,247</td>
<td>5.2</td>
</tr>
<tr>
<td>Public Sector</td>
<td>1,964</td>
<td>8,757</td>
<td>0.9</td>
</tr>
<tr>
<td>Total</td>
<td>13,021</td>
<td>47,004</td>
<td>6.1</td>
</tr>
</tbody>
</table>

Source: Data compiled from SEBI reports

1.8.3 Phase III - Emergence of Private Sector Funds - 1993-96

The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian promoters) to enter the mutual fund industry in 1993, provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor-servicing technology. By 1994-95, about 11 private sector funds had launched their schemes.
1.8.4 Phase IV- Growth and SEBI Regulation - 1996-2004

The mutual fund industry witnessed robust growth and strict regulations from the SEBI after the year 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds. Investors' interests were safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. The Union Budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various Investor Awareness Programmes were launched during this phase, both by SEBI and Association of Mutual Funds in India (AMFI), with an objective to educate investors and make them informed about the mutual fund industry. In February 2003, the UTI Act was repealed and UTI was stripped of its Special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. UTI was re-organized into two parts: 1. The Specified Undertaking, 2. The UTI Mutual Fund.

Presently UTI operates under the name of UTI Mutual Fund and its past schemes (like US-64, Assured Return Schemes) are being gradually wound up. However, UTI Mutual Fund is still the largest player in the industry. In 1999, there was a significant growth in mobilization of funds from investors and AUM which is supported by the table 1.3.
Table 1.3: Category wise AUM

<table>
<thead>
<tr>
<th>As on</th>
<th>UTI</th>
<th>Public sector</th>
<th>Private sector</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>31-March-99</td>
<td>53,320</td>
<td>8,292</td>
<td>6,860</td>
<td>68,472</td>
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</tbody>
</table>

Source: compiled from SEBI reports.

1.8.5 Phase V - Growth and Consolidation

The industry has also witnessed several mergers and acquisitions recently, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life (BSL), Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players. The Indian Mutual Fund Industry is one of the fastest growing segments of the Indian Economy. During the last ten year period the industries has grown at nearly 22 per cent Compounded Annual Growth Rate (CAGR).

1.9 Trend of Gross Resource Mobilization and Redemptions

Resource mobilization by mutual funds is an important activity in the capital markets. The strong potential of the capital market as an area of resource mobilization needs no emphasis and the mutual fund segment of the financial sector would continue to play a significant role in the future. Table 1.4 presents the resource mobilization and redemption trend of mutual funds. It is evident from the table that the net resource mobilization of funds had increased in the year 2003-04 whereas it had shown a
declining trend in the year 2005. From the year 2005 to 2008 the mutual funds industry has witnessed huge inflow of funds followed by high redemptions in the year 2009. It is noticed from the SEBI annual reports that the year 2010 has recorded a growth trend followed by declining trend in the year 2011. This indicates the mutual funds industry is witnessing the fluctuations just like other capital market instruments. Private sector mutual funds have a major contribution towards the inflow of funds when compared to public sector mutual funds. This is due to many new private sector entrants into the mutual funds industry which have surpassed the public sector sponsored firms and were successful in offering high risk adjusted returns. UTI along with other public sector sponsored mutual funds is facing high competition from the private sector sponsored mutual funds. The competition is mainly due to wide array of funds and high returns offered by private sector mutual funds.

Table 1.4 Trend of Gross Mobilization & Redemption of Mutual Funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Mobilisation</th>
<th>Redemptions</th>
<th>Net</th>
<th>Assets at the end of the period</th>
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<tr>
<td>2001-02</td>
<td>164523</td>
<td>157348</td>
<td>7175</td>
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<td>2002-03</td>
<td>314706</td>
<td>310510</td>
<td>4196</td>
<td>109299</td>
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<td>2003-04</td>
<td>590190</td>
<td>543381</td>
<td>46808</td>
<td>139616</td>
</tr>
<tr>
<td>2004-05</td>
<td>839708</td>
<td>837508</td>
<td>2200</td>
<td>149600</td>
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<tr>
<td>2005-06</td>
<td>1098149</td>
<td>1045370</td>
<td>52779</td>
<td>231862</td>
</tr>
<tr>
<td>2006-07</td>
<td>1938493</td>
<td>1844508</td>
<td>93985</td>
<td>326292</td>
</tr>
<tr>
<td>2007-08</td>
<td>4464376</td>
<td>4310575</td>
<td>153802</td>
<td>505152</td>
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<tr>
<td>2008-09</td>
<td>5426353</td>
<td>5454575</td>
<td>-23296</td>
<td>417300</td>
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<td>2009-10</td>
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<td>6819678</td>
<td>6841702</td>
<td>-22024</td>
<td>587217</td>
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</table>

Source: SEBI annual reports
India has been one of the fastest growing markets in the mutual funds industry. The AUM as per cent of deposits in the year 2000 was 11.3 per cent and has rose to the extent of 19 per cent in the year 2009 and has recorded only 15.2 per cent due to lack of awareness of mutual funds as per KPMG Confederation of Indian Industry (CII) report. The AUM as per cent of market capitalization in the year 2000 was 14.4 per cent which has declined gradually over the years till 2007 and subsequently rose to 13.1 per cent in the year 2007 and further came down to 10 per cent in the year 2010. The AUM per cent of GDP as shown in the figure 1.5 was at 5.3 per cent which happened to have small contribution from the mutual fund industry. The later years has shown a significant rise due to the changes in the financial markets and downtrend of interest rates on bank deposits and other financial assets. Even after the changes 55 per cent of India’s household continued to hold assets in fixed deposits, 18 per cent in insurance and 10 per cent in currency as per the statistics of CII 2009. The
years 2010 to 2012 saw a down trend in contribution to the GDP from the mutual fund industry. The statistics of Business today revealed that India's mutual fund industry is at 8 per cent of GDP as on August 2012. It also revealed that Australia's is 105 per cent, the US's is 77 per cent, and France's 50 per cent. Brazil's is approximately 40 per cent of GDP and the sixth largest in the world. China and Russia lag behind India. As per the survey report of CII, Indian mutual fund industry is still in its nascent stage and has a huge potential which can be tapped mainly from the rural and semi urban investors.

Source: CII mutual funds summit 2010

**Chart 1.3 AUM and GDP**

1.11 Trend of mutual fund by structure

The following table 1.5 represents the growth trend of the schemes in terms of number of schemes. There was increase in the trend of open ended schemes from the year 2001 to 2012. The closed ended scheme has also shown growth but there was a decline in number of closed ended funds in the year 2004 and 2009 when compared to its previous years.
Table 1.5 Trend of number of schemes

<table>
<thead>
<tr>
<th>Year</th>
<th>Open-ended Schemes</th>
<th>Closed-ended Schemes</th>
<th>Interval schemes</th>
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<td>2001</td>
<td>307</td>
<td>110</td>
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<td>2002</td>
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<td>2010</td>
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<td>36</td>
</tr>
<tr>
<td>2011</td>
<td>745</td>
<td>530</td>
<td>34</td>
</tr>
<tr>
<td>2012</td>
<td>745</td>
<td>512</td>
<td>34</td>
</tr>
</tbody>
</table>

Source: Sebi annual reports

Chart 1.4 Trend of number of open, closed and interval schemes

1.11.1 Closed-end Funds

Funds that can sell a fixed number of units only during the New Fund Offer (NFO) period are known as Closed-end Funds. The corpus of a Closed-end Fund remains unchanged at all times. After the closure of the offer, buying and redemption of units by the investors directly from the Funds is not allowed. However, to protect the interests of the investors, SEBI provides investors with two avenues to liquidate their positions.
Closed-end Funds are listed on the stock exchanges where investors can buy/sell units from/to each other. The trading is generally done at a discount to the Net Asset Value (NAV) of the scheme. The NAV of a closed-end fund is computed on a weekly basis (updated every Thursday). Closed-end Funds may also offer "buy-back of units" to the unit holders. In this case, the corpus of the Fund and its outstanding units do get changed. There were 110 closed ended schemes in the year 2001 which has risen to 512 in the year 2012.

1.11.2 Open Ended Mutual Funds

Funds that can sell and purchase units at any point in time are classified as open-end Funds. The fund size (corpus) of an open-end fund is variable (keeps changing) because of continuous selling (to investors) and repurchases (from the investors) by the fund. An open-end fund is not required to keep selling new units to the investors at all times but is required to always repurchase, when an investor wants to sell his units. The Net Asset Value (NAV) of an open-end fund is calculated every day. The data collected from the SEBI annual reports reveal that there were 307 open ended schemes offered in the year 2001 which have increased to 745 schemes as on March 2012.

1.11.3 Interval Schemes

Interval Schemes are that schemes, 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.
1.12 By Investment Objective

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 flavors, 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.

- **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 (normally 50:50).

- **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 per cent of each stock to the total holding will be identical to the stocks index weightage. Hence, the returns from such schemes would be more or less equivalent to those of the Index.

- **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.

- **International ETFs** - ETFs that invest in a single foreign country may carry higher risks than international ETFs that spread their investments among many countries. If a single country undergoes a major recession or other financial hardship, an ETF that only invests in securities based there could have a major performance shortfall. In general, expense ratios for international ETFs tend to be higher than the averages because of the higher costs to invest abroad. There are
seven International ETFs traded on NSE as indicated on the NSE website.

- There are 24 ETFs traded on Bombay Stock Exchange (BSE). Currently there are three types of ETFs which can be traded in BSE. These are Equity ETFs, Gold ETFs and Liquid ETFs. Equity ETF is a basket of stocks that reflects the composition of an Index, like S&P CNX Nifty or BSE SENSEX. The ETFs trading value is based on the net asset value of the underlying stocks that it represents. Presently there are eleven equity ETFs which are traded in BSE. Gold ETF is a special type of Exchange traded fund that tracks the price of gold. Currently there are six gold ETFs which can be traded in BSE. Liquid ETFs are the money market ETFs, the investment objective of which is to provide money market returns. Liquid BES launched by benchmark mutual fund is the first money market ETF in the world. Liquid BeES will invest in a basket of call money, short-term government securities and money market instruments of short and medium maturities.

1.13 Various Investment Options Mutual Funds Offer

To cater to different investment needs, Mutual Funds offer various investment options. Some of the important investment options include:

- **Growth Option** - Dividend is not paid-out under a Growth Option and the investor realizes only the capital appreciation on the investment (by an increase in NAV).

- **Dividend Payout Option** - Dividends are paid-out to investors under the Dividend Payout Option. However, the NAV of the mutual fund scheme falls to the extent of the dividend payout.
- **Dividend Re-investment Option** – The dividend accrued on mutual funds is automatically re-invested in purchasing additional units in open-ended funds. In most cases, mutual funds offer the investor an option of collecting dividends or re-investing the same.

- **Retirement Pension Option** - Some schemes are linked with retirement pension. Individuals participate in these options for themselves and corporates participate for their employees.

- **Insurance Option** - Certain Mutual Funds offer schemes that provide insurance cover to investors as an added benefit.

- **Systematic Investment Plan (SIP)** – Under this plan, the investor is required to save a fixed amount every month. The investor is allotted units on a predetermined date specified in the offer document at the applicable NAV.

- **Systematic Withdrawal Plan (SWP)** - As opposed to the SIP, the Systematic Withdrawal Plan allows the investor the facility to withdraw a pre-determined amount / units from his fund at a pre-determined interval. The investor's units will be redeemed at the applicable NAV as on that day.

- **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.

### 1.14 Comparison of Mutual Funds with Other Products

The mutual fund sector operates under strict regulations as compared to most other investment avenues. They differ from other products
with respect to tax and legal comfort. Mutual funds differ in characteristics from fixed deposits in banks, company fixed deposits, bonds and debentures, equity, life insurance and pension funds.

- **Equity Versus Mutual Funds** - Equity security which is not traded in the market place has a problem of realizing value from it whereas investment in open ended mutual fund eliminates the direct risk of not being able to sell the investment in the market. However, indirect risk remains because the scheme has to realize its investments to pay it to the investors. The AMC is however better than an individual investor to handle the situation. Another important distinction between equity and mutual fund is mutual fund schemes give the advantage of diversification through a small investment.

- **Life Insurance Versus Mutual Funds** - Life Insurance is a hedging tool and in fact it is not really an investment option. Insurance companies offer policies of different types like term plans which cover only risk, and others which have an element of savings accumulation and unit linked insurance plans with high front end costs, largely on distribution expenses, which impact the net return on savings component of endowment policies.

- **Pension Funds Versus Mutual Funds** - Pension schemes can be defined benefit schemes and defined contribution schemes. Defined benefit schemes are where the pensioner gets a benefit that is linked to the average salary the person drawing around the time of retirement. The benefit may be also inflation indexed. People working in central and public sector companies traditionally earned pension in the form of defined benefit. Defined contribution schemes
are where the pensioner’s contribution during the persons working years is fixed. Pension funds are a vehicle for accumulation of long term savings. The government’s plan of enforcing an extremely low cost structure could be the basis for better returns for investors than in the case of insurance and mutual funds. Mutual funds have products for long term as well as short term. They are such types of products where investors can invest as per their risk preferences.

1.15 Risk Factors of Mutual Funds

The risk return trade-off indicates that if investors are willing to take higher risk, then correspondingly can expect higher returns and vice versa (if they pertains to lower risk instruments, which would be satisfied by lower returns).

Chart 1.5 The Risk-Return Trade-off

If the investors prefer mutual funds as their primary means of investing, these provide professional management, diversification, convenience and liquidity. That doesn’t mean mutual fund investments are risk free. This is because the money that is pooled is not invested only in debts funds which are less risky but are also invested in the stock markets
which involves a higher risk but can expect higher returns. There are also certain funds which are known as hedge funds. These hedge funds involve a very high risk since they are mostly traded in the derivatives markets which are considered very volatile.

Thus, it is very most important to understand is the risk-return trade-off of mutual funds. Higher the risk greater the returns/loss and lower the risk lesser the returns/loss.

1.16 Risk Hierarchy of Different Mutual Funds

Different mutual fund schemes are exposed to different levels of risk and investors should know the level of risks associated with these schemes before investing. The following are the types of risks:

- **Market Risk** - Sometimes prices and yields of all securities rise and fall due to external factors affecting the market in general. This is known as Market Risk. A Systematic Investment Plan (SIP) that works on the concept of Rupee Cost Averaging might help mitigate this risk.

- **Credit Risk** - The debt servicing ability (May it be interest payments or repayment of principal) of a company through its cash flows determines the Credit Risk faced by the investor. This credit risk is measured by independent rating agencies like CRISIL who rate companies and their paper. ‘AAA’ rating is considered the safest whereas a ‘D’ rating is considered poor credit quality. A well-diversified portfolio might help mitigate this risk.
- **Inflation risk** - Inflation is the loss of purchasing power over time. A lot of times people make conservative investment decisions to protect their capital but end up with a sum of money that can buy less than what the principal could at the time of the investment. This happens when inflation grows faster than the return on investment. A well-diversified portfolio with some investment in equities might help mitigate this risk.

- **Interest Rate Risk** - In a free market economy interest rates are difficult if not impossible to predict. Changes in interest rates affect the prices of bonds as well as equities. If interest rates rise the prices of bonds fall and vice versa. Equity might be negatively affected as well in a rising interest rate environment. A well-diversified portfolio might help mitigate this risk.

- **Political/Government Policy Risk** - Changes in government policy and political decision can change the investment environment. They can create a favorable environment for investment or vice versa.

- **Liquidity Risk** - Liquidity risk arises when it becomes difficult to sell the securities that one has purchased. Liquidity Risk can be partly mitigated by diversification, staggering of maturities as well as internal risk controls that lean towards purchase of liquid securities.

### 1.17 Some Performance Measures for Mutual Funds

Risk and investing go hand in hand. Apart from comparing the performance with the benchmarks, an investor should also make use of certain statistical measures that make evaluation of a mutual fund even more precise. Among the most commonly used ratios, there are six ratios, which the investors come across very often but fail to understand their
utility. They are Standard Deviation, Beta, Sharpe, Jensen, Treynor and R-Squared. All these measures are based on the assumptions that (i) investors are risk averse and are single period expected utility of terminal wealth maximizers, (ii) all investors have identical decision horizons and homogenous expectations regarding investment opportunities, (iii) all investors are able to choose among portfolios solely on the basis of expected returns and variance of returns, (iv) no transaction costs and taxes and all assets are infinitely divisible.

**Summary**

With the booming Indian economy in all areas, the financial sector in particular is growing rapidly in the recent past. The Indian mutual fund industry, today presents a picture of opportunity and challenges. As the industry is undergoing changing regulatory landscape, business strategies are endeavouring to respond to these developments. Amidst these changes, AMCs and all service providers have to re-examine their business models and embrace the changing business landscape. Further, the investors need to understand the products offered by AMCs and their performance so as to choose the right investment option.