Chapter 2 – Mutual Funds: Evolution, Significance and Indian Market

2.1. ORIGIN OF MUTUAL FUNDS

In the past two decades, mutual funds have become the crucial investment vehicle for a small investor. Just after the beginning of twenty-first century, the number of mutual funds in the United States exceeded the number of securities listed on the New York Stock Exchange\textsuperscript{65}. This indicates the popularity and significance of this investment vehicle in one of the largest economy of the world. While comparing to direct investments in individual stocks and bonds, mutual funds offer several advantages of liquidity and diversification at a relatively lower cost. While the popularity of mutual funds is relatively recent, the origin of mutual fund can be traced back to the early days of organized stock trading.

The founding of the Foreign and Colonial Government Trust in 1868 marks the beginning of mutual funds in the Anglo-Saxon countries. However, by that time investment trusts had existed in Holland for almost a century. In 1774 the Dutch merchant and broker Abraham van Ketwich invited subscriptions from investors to form

\textsuperscript{65} Investment Company Institute Mutual Fund Factbook reports more than 8,000 mutual funds in the U.S. in 2002, compared to 2,800 firms listed on the NYSE.
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A trust named Eendragt Maakt Magt—the maxim of the Dutch Republic, “Unity Creates Strength.” The founding of the trust followed the financial crisis of 1772–1773, and Van Ketwich’s aim was to provide small investors with limited means an opportunity to diversify. Risk spreading was achieved by investing in Austria, Denmark, Germany, Spain, Sweden, Russia, and a variety of colonial plantations in Central and South America.

The first mutual fund originated in a capital market that was in many ways well developed and transparent. More than one hundred different securities were regularly traded on the Amsterdam exchange and the prices of the most liquid securities were made available to the general public through broker sheets and, at the end of the century, a price courant—a bi-weekly publication that in addition to security prices listed real estate transactions and announcements of dividends and security offerings. The bulk of trade took place in bonds issued by the Dutch central and provincial governments and bonds issued by foreign governments that tapped the Dutch market.

The governments of Austria, France, England, Russia, Sweden, and Spain all came to Amsterdam to take advantage of the relatively low interest rates. Shares were scarce, and the most liquid issues were the Dutch East India Company, the Dutch West India Company, the British East India Company, the Bank of England, and the South Sea Company. The other major category of securities consisted of plantation loans—or negotiates as they were known in the Netherlands. Issued by merchant-financiers, these bonds were collateralized by mortgages to planters in the Dutch West Indies colonies Berbice, Essequebo, and Suriname.

Mutual funds emerged gradually, as merchants and brokers learned how to expand the range of investment opportunities to the general public during the eighteenth century. The two principal innovations that took place were securitization and stock exchange trading.

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67 J. Riley, International Government Finance and the Amsterdam Capital Market 1740–1815 (Cambridge: Cambridge University Press, 1980), points out that this term has no direct counterpart in the modern English language. In eighteenth century Holland, it applied to any investment undertaking organized and managed by a financial intermediary which sold shares to the general public.
substitution. Securitization uses the cash flows of illiquid claims as collateral for securities that can be traded in financial markets. In a stock substitution, existing securities are repackaged individually or as part of a portfolio to make them easier to trade, either in smaller denominations or at a lower cost than the underlying claims. Often these innovations were designed to overcome barriers associated with investing abroad, such as foreign registration requirements and the costs of collecting interest or dividends, which prevented smaller investors from participating in securities markets. This broadening of the Dutch capital market eventually led to the introduction of the forerunners of today’s closed-end mutual funds and depository receipts.

**Antecedents of Mutual Funds**

Prior to the eighteenth century a number of investment vehicles emerged that created a joint interest in a pool of financial and non-financial assets. While these securities were not identical to modern mutual funds, they manifested many of the same characteristics. Their evolution sheds light on the first investment trusts to create tradable ownership of a financial securities portfolio. The first major type is a contract of survival. These included life annuities and, in particular, tontines. The second type includes plantation loans.

Life annuities are financial contracts whereby borrowers pay interest to the lender for the remainder of the lender’s life, or that of a third person named in the contract. They differ from term loans, wherein the principal of the loan is repaid at the end of a pre-specified term in the contract. Life annuities probably date back as early as 205 B.C. and they were quite common in the middle ages in France and Northern Europe before becoming an important vehicle for public finance in the seventeenth and eighteenth centuries. One particularly interesting variation on life annuities was known as the tontine that used to bear some resemblance to mutual funds. In a tontine, a borrower promises to pay to a group of individuals an annuity which will be divided among the surviving members. As members die, the payout to the survivors increases.

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Many early tontines were organized by governments, but examples of private tontines are known to date back to the seventeenth century. Unlike public tontines, in which the payment promise was backed by the power of taxation, private tontines required some form of collateral to guarantee the periodic payments to participants. This was often accomplished by using the participants’ initial contributions to purchase financial securities. If the underlying portfolio paid interest at a fixed rate, then—barring default of the securities—the annual payments could be guaranteed. For example a private tontine with ten participants issued in the Town of Broek op Waterland in the Netherlands invested in bonds of Emperor Charles VI, which were collateralized by the proceeds of his possessions. If the investment portfolio of a private tontine consisted of company shares, no fixed payments could be guaranteed, and the best participants could only hope the company would continue its dividend policy. This was the case with a 1670 private tontine organized in Amsterdam among thirty participants who jointly invested in a share of the Middelburg chamber of the Dutch East India Company.

This private tontine is an example of a “capital tontine,” in which the participants jointly owned the collateral. The difference from mutual funds became increasingly fine over time, as private tontine societies invested in diversified portfolios. For example, a private tontine organized in The Hague in 1770 under the name Uit Voorzorg invested its initial contributions in a portfolio of securities that closely resembled the investments of Eendragt Maakt Magt and other early mutual funds. However, shares in a tontine were difficult to transfer because they were tied to the lives of its participants, and the objective of tontines was income smoothing rather than providing diversification or portfolio management to its participants. According to the directors of Uit Voorzorg, the society intended to use its revenues “to pay its members an annual sum of money in the form of a pension.”

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70 (English Translated Version) Wagenvoort, “Tontines,” 127
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The second type of security that shares characteristics with mutual funds is the eighteenth century plantation loan, which securitized mortgages to planters in the West Indies. The practice of transforming private loans into publicly traded securities was pioneered by the firm of Deutz & Co. Johan Deutz was the factor of the Austrian emperor, and as early as 1695 Deutz advanced him loans requiring the revenues from his mercury mines as security. Subsequent loans to the emperor were financed by organizing a negotiație under the direction of his heirs, who issued bonds in the Dutch capital market using these revenues as security. In 1753 the firm of Deutz—then led by Gideon Deutz, also mayor of Amsterdam—applied the same technique to mortgage loans to West Indies plantation owners. The firm played a dual role of financier and commission agent. Deutz arranged to issue bonds in the Dutch capital market and used the proceeds to provide mortgages to the plantation owners in Suriname. In return, the owners were obliged to ship their crops back to Deutz, who acted as their commission agent in the Netherlands. The proceeds from these sales—as well as the real property of the plantations, including the equipment and the slaves—served as security for the interest and principal payments to the bondholders.

The plantation loans contain some elements of an investment trust, but their investments—mortgages to planters—were not securities in themselves, which disqualifies these negotiațies as mutual funds. Furthermore, their primary purpose was not to provide diversification or portfolio services to the general public. Merchants used their reputation to mobilize capital on behalf of planters in return for the right to factor shipments of tobacco, cocoa, and coffee. By issuing the bonds, they could expand their business without tying up the firm’s capital. Nevertheless, the plantation loans were an important innovation in their own right because they securitized the debt service of loans to planters. As such, they can be viewed as the forerunners of modern mortgage-backed securities. Many of the early mutual funds allocated a significant portion of their portfolios to plantation loans, closely linking their fortunes when continental European

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conflicts led to a reshuffling of colonial possessions near the end of the eighteenth century.

**Eendragt Maakt Magt: The Early Investment Trust**

In July of 1774, an Amsterdam broker by the name of Abraham van Ketwich invited subscriptions to a negotiatie named Eendragt Maakt Magt. The negotiatie would invest in bonds issued by foreign governments and banks and in plantation loans in the West Indies. Investors were promised a dividend of 4 percent, with adjustments depending on the annual investment income of the portfolio. The initial plan was to dissolve the negotiatie after twenty-five years, at which time the liquidation proceeds would be distributed among the then remaining investors. Subscription was open to the public until all 2,000 shares were placed; thereafter participation in the fund would only be possible by purchasing shares from existing shareholders in the open market. Investors had a choice to either receive shares registered in their name, or purchase shares in bearer form (in blanco). The transfer of bearer shares was easier because it did not require registration with the issuer, but both types were freely tradable. Based on these characteristics, Eendragt Maakt Magt would most likely be classified today as a closed-end mutual fund, which issues a fixed number of shares representing ownership of a portfolio of tradable securities. According to W.H. Berghuis, it is considered the first “mutual fund.”

The organizers were apparently quite sensitive to their fiduciary responsibilities to investors. The prospectus required Van Ketwich to provide an annual accounting to the commissioners and produce, upon request, full disclosure to all those interested parties, as to ensure “good and proper management at all times.” For his services, the administrator would receive a commission of 0.5 percent at the founding of the trust,

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73 (English Translated Version) W.H. Berghuis, “Onstaan en Ontwikkeling van de Nederlandse Beleggingsfondsen tot 1914” (diss., Assen: Van Gorcum & Company, 1967). A 1773 plan for similar investment trust organized in Utrecht has survived, but it is not known whether it was ever successfully placed on the market.
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plus an annual compensation of 100 guilders per class.\textsuperscript{74} The physical securities that the trust invested in were stored at the office of Van Ketwich in an “iron chest with three differently working locks” to which the commissioners and the notary public kept the keys. In addition to specifying its investments, the prospectus required that the portfolio would be diversified at all times. The 2,000 shares of Eendragt Maak Magt were subdivided into twenty “classes,” and the capital of each class was to be invested in a portfolio of fifty bonds. Each class was to consist of at least twenty to twenty-five different securities, to contain no more than two or three of a particular security, and to “observe as much as possible an equal proportionality.”

Despite this explicit diversification requirement, Eendragt Maakt Magt contained a curious and complicated lottery, which, from a diversification perspective, imposed unnecessary risks on its investors. The lottery worked as follows: not all investment income from the portfolio would be passed on to the fund investors, but a portion was to be used to retire shares by lot at a premium and also increase dividends to some of the outstanding shares. Specifically, the promised dividend payout of the fund was 4 percent per annum, which was below the nominal interest rate on the bonds it invested in. As long as the bonds in the portfolio did not default, the excess of income over payout would accrue in a cash reserve account, which was used annually to repurchase one share determined by lot from each class at a premium of 20 percent over par. At the same time future dividends on the neighboring shares would be increased. To accurately value each share, investors would have to know either the dividend on all the other shares or the numbers of the retired shares and the order of redemption.

Although curious from a modern day perspective, lotteries were a common element of eighteenth century securities, and it is likely that Van Ketwich modeled his investment trusts after other existing negotiatives. The embedded lottery should not detract from the significance of Eendragt Maakt Magt: it offered investors an opportunity to participate in and trade a diversified portfolio of securities. Because the

\textsuperscript{74} This translates into an annual management fee of 0.2 percent of assets, which is low even by modern standards
prospectus allowed little flexibility with respect to the fund’s investment policies, it is unlikely that Van Ketwich aimed to attract investors by offering superior returns through professional portfolio management. Eendragt Maakt Magt simply repackaged existing securities that were already traded in the Amsterdam market.

The negotiatie was likely aimed at smaller investors, who would be unable to achieve this level of diversification on their own account. The bonds in its portfolio had a face value of 1,000 guilders, and replication of the portfolio by purchasing these securities in the open market was only feasible for investors of considerable wealth. Eendragt Maakt Magt created an opportunity to obtain portfolio diversification in portions of 500 guilders.\(^75\)

Little direct evidence exists about what motivated Van Ketwich to organize the fund, but circumstantial evidence is consistent with the objective of diversification. Its inception follows the financial crisis of 1772–1773, which bankrupted British banks due to overextension of their position in the British East India Company. When the crisis spread to Amsterdam, several banking houses were pushed to the brink of default. Being a broker, Van Ketwich may have perceived a sentiment for diversified investments among his clientele. Subsequent negotiaties in which Van Ketwich was involved explicitly advertise the benefits of diversification to attract small investors. It is perhaps surprising that the portfolio did not include equity shares or domestic and British bonds, but share material was relatively scarce, and domestic interest-bearing securities were available in small denominations.

**Subsequent Mutual Funds**

The initial success of Eendragt Maakt Magt soon invited followers. In 1776 a consortium of Utrecht bankers founded the negotiatie “Voordeelig en Voorsigtig” (Profitable and Prudent). This time Abraham van Ketwich did not act as an administrator, but the prospectus lists his office as a collection agency for periodic dividend payments, which

suggests that he was closely involved. The forty percent of the portfolio of Voordeelig en Voorsigtig was to be allocated to plantation loan, although these were not detailed by name. The most interesting difference is that shares of Eendragt Maakt Magt were listed among the potential investments of the fund. In 1779, Abraham van Ketwich introduced his second mutual fund under the name “Concordia Res Parvae Crescunt”, the Latin origin of Eendragt Maakt Magt. While Van Ketwich’s second fund resembled his first in both name and structure, an important difference was that he opted for more freedom in investment policy. The prospectus only states that the negotiatie would invest in “solid securities and those that based on decline in their price would merit speculation and could be purchased below their intrinsic values, of which one has every reason to expect an important benefit,” a phrasing which suggests that Concordia Res Parvae Crescunt may be the grandfather of modern value funds.

Performance of Early Mutual Funds
The fortunes of the early mutual funds are closely linked to the fortunes of their predominant investments—plantation loans in the West Indies. The outbreak of the Fourth English War in 1780 hampered colonial shipments to their Dutch commission agents, affecting the proceeds that were pledged as the security for holders of the plantation loans. For example, the price of Deutz’s first plantation loan fell by 35–40 percent and bondholders were asked to accept interest rate reductions. In 1782, the decline in investment income forced Van Ketwich to suspend the redemption of shares in Eendragt Maakt Magt and lower dividend payments several years later. By the end of the century all three funds had disappeared from the official published price record of the Amsterdam stock exchange, and transaction prices show up only at irregular private auctions by securities brokers. In 1799, at the end of the scheduled life of Eendragt Maakt Magt, participants agreed to extend the negotiatie until the shares could be redeemed at par. In 1803 the management of the affairs of Eendragt Maakt Magt and

76 (English Translated Version) “Concordia res parvae crescent, discordia maximae dilabuntur” is attributed to the Roman historian Sallust, meaning “In harmony small things grow, dissention dissolves the greatest.”
Concordia Res Parvae Crescunt were taken over by the firm of Van Ketwich and Voomberg. By 1811 the share price of Eendragt Maakt Magt reached a low of 25 percent of its nominal value of 500 guilders, but eventually recovered. This seems miraculous, but the fund actively repurchased shares in the open market when prices were depressed. In 1824, a liquidating dividend of 561 guilders was paid to the remaining participants. Final settlement of shares in Concordia Res Parvae Crescunt took substantially longer. It existed for 114 years, until 1893 when it was officially dissolved. In 1894, a final distribution of 430.55 guilders per share of 500 guilders was paid, or 87 percent of the original investment. Despite its misfortunes, or perhaps due to them, Concordia Res Parvae Crescunt is probably the longest mutual fund to have ever existed. But despite the poor performance of the first investment trusts, there are also many success stories. During the 1780s and 1790s more than thirty investment trusts emerged with a single objective: speculation on the future credit of the United States. Together with France and Spain, the Netherlands was one of the major financiers of the American Revolution. Between 1782 and 1791, an estimated 32 million guilders were raised in Amsterdam and Antwerp, much of which was spent to finance supplies.

**Nineteenth-century Mutual Funds**

The first investment trust outside of the Netherlands is the Foreign and Colonial Government Trust, founded in 1868 in London. Like Eendragt Maakt Magt, it invested in foreign government bonds. According to its prospectus, the goal was to provide “the investor of moderate means the same advantages as the large capitalist, in diminishing the risk of investing in foreign and colonial government stocks, by spreading the investment over a number of different stocks.” It was modeled after the Dutch trusts in the sense that investment income was projected to exceed dividends, and excess income would be used to liquidate shares over its projected twenty-four-year life. By 1875 eighteen trusts had been formed in London.\(^7^8\) It was during this period that the Scotsman Robert Fleming started his famous first trust, investing in U.S. railroad bonds, later named the First Scottish American Investment Trust. During the 1890s, investment

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trusts were introduced into the United States. Most of the early U.S. investment trusts were closed-end funds, like Eendragt Maakt Magt, issuing a fixed number of shares. The issue of new shares, or repurchases, were not prohibited but were infrequent. Moreover, the repurchase or issue price was not necessarily proportional to the intrinsic value of the underlying portfolio. This changed in 1924, when the Massachusetts Investors Trust became the first U.S. mutual fund with an open-end capitalization, allowing for the continuous issue and redemption of shares by the investment company at a price that is proportional to the value of the underlying investment portfolio. The fund went public in 1928, eventually spawning the mutual fund firm known today as MFS Investment Management. State Street Investors’ Trust was the custodian of the Massachusetts Investors’ Trust. Later, State Street Investors started its own fund in 1924 with Richard Paine, Richard Saltonstall and Paul Cabot at the helm. Saltonstall was also affiliated with Scudder, Stevens and Clark, an outfit that would launch the first no-load fund in 1928. A momentous year in the history of the mutual fund, 1928 also saw the launch of the Wellington Fund, which was the first mutual fund to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.79

Open-end capitalization has become the dominant model for mutual fund organization, suggesting that it has been an important innovation contributing to its modern success. One cannot fail to be surprised; however, by how many of the features of eighteenth-century investment funds have survived until today.

2.2 EVOLUTION OF MUTUAL FUNDS IN INDIA

The Indian capital market having a long history spanning over a century had passed through the most radical phase. The Indian Capital Market witnessed unprecedented developments and innovations during the eighties and nineties. One such development was the increased role the mutual fund industry played in financial intermediation. Mutual fund, as an institutional device, pools investor’s funds for investment in the

capital market under the direction of an investment manager. Mutual funds bridged the gap between the supply and demand for funds in the financial market.

In India, the need for the establishment of mutual funds was felt in 1931 and the concept of mutual fund was coined in 1964, by the intuitive vision of Sri T.T. Krishnamachari, the then finance minister. Taking into consideration the recommendations of the Central Banking Enquiry Committee and Shroff Committee, the Central Government established Unit Trust of India in 1964 through an Act of Parliament, to operate as a financial institution as well as an investment trust by way of launching UTI Unit Scheme 64. The overwhelming response and the vast popularity of UTI Unit Scheme 64 and the Mastershare Scheme in 1986 attracted the attention of banks and other financial institutions to this industry and paved the way for the entry of public sector banks. By the end of 1986-87, UTI had launched 20 schemes mobilizing funds amounting to Rs.4,56,500 crores.80

Since then, the mutual funds have established themselves as an alternative investment vehicle and are now an integral part of the Indian financial system. In 1987, the public sector banks and insurance companies were permitted to set up mutual funds. Accordingly, the LIC and GIC and six public sector banks initiated the setting up of mutual funds, bringing out a new era in the mutual fund industry. The financial sector reforms were introduced in India as an integral part of the economic reforms in the early 1990s with the principal objective of removing structural deficiencies and improving the growth rate of financial markets. Mutual fund reforms attempted for the creation of a competitive environment by allowing private sector participation. Since 1991, several mutual funds were set up by private and joint sectors. Many private mutual funds opted for foreign collaboration due to the technical expertise of their counterparts and past track record of success. Based on the recommendations of the Dave panel report in 1991, the Government of India issued new guidelines for setting up mutual funds in public sector, private sector as well as in joint sector on February 14,

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1992. On February 19, 1993, the first batch of 12 private sector mutual funds was given “in-principle approval” by the Securities Exchange Board of India (SEBI). The erstwhile Kothari Pioneer Mutual fund (now merged with Franklin Templeton) was the first fund established in July 1993 in the private sector.

The SEBI formulated the Mutual Fund Regulations in 1993, establishing a comprehensive regulatory framework for the first time, while the Indian Mutual Fund Industry (IMFI) had already passed through two phases of developments. The first phase was between 1964 and 1987 when the UTI was the only player, managing total assets of Rs.4,564 crores by the end of March 1987. In 1986, the first growth scheme, Mastershare was launched by UTI and was the first to be listed on stock exchange.

The second phase was between 1987 and 1993 during which period eight funds were established (six by banks and one each by LIC and GIC). SBI Mutual Fund was the first non UTI mutual fund established in June 1987, followed by Canbank Mutual Fund in December 1987. SBI Mutual Fund launched its first scheme namely, Regular Income Scheme (RIS) 1987 with 5½ years of duration assuring 12 percent return. Canbank Mutual Fund launched its first scheme, Canshare in December 1987 mopping up Rs.4 crores. The total assets managed by the industry shot upto Rs.47,004 crores by the end of March 1993.\(^81\)

The third phase began with the entry of private and foreign sector mutual funds in 1993 increasing the share of private players. The industry evolved self-regulation to promote confidence among investors under the aegis of the Association of Mutual Funds of India (AMFI) incorporated on August 22, 1995 as a non-profit organisation. With the objective of ensuring healthy growth of mutual funds, the SEBI (Mutual Funds) Regulations 1993 were substituted by a more comprehensive and revised regulations in 1996 bringing out standards in Net Assets Value (NAV) calculation, accounting practices, exemption from listing of schemes, remuneration to Asset Management Company’s

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(AMC), fixation of a band of seven percent between purchase and repurchase prices. Since October 1999, Money Market Mutual Funds was brought under the supervisory control of SEBI on par with liquid funds. The acquisition of Pioneer ITI by Templeton in August 2000 was one of the biggest mergers in the IMFI. At the end of January 2003, there were 33 mutual funds managing total assets of Rs.1,21,805 crores after witnessing several mergers and acquisitions. The total Assets Under Management (AUM) of the mutual fund houses in the country crossed Rs. One trillion in June 2003, a decade after the entry of private sector in mutual fund business.  

The fourth phase had its beginning from February 2003, following the repeal of the Unit Trust of India Act 1964, bifurcating UTI into two separate entities, namely UTI Specified Undertaking regulated by Government of India and UTI Mutual Fund Ltd regulated by SEBI. With mergers taking place among mutual funds, the mutual fund industry entered its fourth phase of consolidation and growth. By the end of September 2004, there were 29 funds, managing assets of Rs.1,53,108 crores under 421 schemes. The industry touched Rs. 2 trillion in September 2005. The growth rate of the industry scaled up, as the next milestone of Rs. Three trillion was reached in August 2006.  

2.3 ROLE AND SIGNIFICANCE OF MUTUAL FUNDS IN INDIAN ECONOMY

Financial sector development can be viewed as a process that enhances four critical attributes of the financial system: efficiency, stability, transparency and inclusion. The emergence of intermediation mechanisms and products that help improve on one or more of these without causing others to weaken are, therefore, a meaningful indicator of financial development.

From this perspective, Mutual Funds play an important role in the development of the financial system. First, they pool the resources of small investors together, 

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increasing their participation in financial markets, which helps both inclusion and the efficient functioning of markets themselves, as a result of larger volumes. Second, Mutual Funds, being institutional investors, can invest in market analysis generally not available or accessible to individual investors, thereby providing services based on informed decisions to small investors. Decisions made on the basis of deeper understanding of risks and returns contribute to financial stability, besides helping to mitigate market risk for this group of investors. Third, transparency in investment strategies and outcomes, though typically mandated by regulators, is relatively easy to deliver on, so that investors can find out exactly where they stand with regard to their investments at any point of time.

As far as regulation is concerned, Mutual Funds cut across domains. The Reserve Bank of India regulates three categories of financial markets; money markets, government securities markets and foreign exchange markets. Mutual Funds have a presence in the first two and the Reserve Bank is therefore interested in the role that they play in developing them.

2.3.1. Mutual Funds as a financial service
According to the Global Asset Management 2006 Report from Boston Consulting Group, India-managed assets will exceed more than $1 trillion by 2015. This means an annual growth rate of more than 20% for the next few years. The Indian mutual funds industry has been growing at a healthy pace of more than 16 per cent for the past more than eight years and the trend will move further as has been emphasized by the report. With the entrance of new fund houses and the introduction of new funds into the market, investors are now being presented with a broad array of Mutual Fund choices. The total asset under management of Mutual Fund industry rose by 9.45% from Rs.309953.04 crores to 339232.46 crores in November, 2006 as published by AMFI. In

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1987, its size was Rs.1,000 crores, which went up to Rs. 4,100 crores in 1991 and subsequently touched figure of Rs.72,000 crores in 1998. Since then this figure has been increasing tremendously and thus revealing the efficiency of growth in the mutual fund industry. On March 2011, the total AUM touched the mark of Rs. 5,92,250 crores.86

It has generally been observed that as the GDP of a country starts moving up, the share of AUM as a percentage of household financial assets start to increase. At present, India has a GDP of around $3,000 on a per capita basis and the AUM as a percentage of household financial assets is under 4%. This is undoubtedly very low as compared to other countries. As India’s GDP is expected to maintain its growth rate, households will surely be holding more assets through mutual fund than ever before. The tremendous growth of Indian Mutual Funds industry is an indicator of the efficient financial market we are currently having and the trust which investors have on the regulatory environment.

2.3.2. Mutual Funds and Market Development

Mutual Funds have contributed significantly in broadening and deepening of different segments of the Money Market and, to some extent, the Government Securities market. Money Market Mutual Funds (MMMFs) were introduced in India in April 1991 to provide an additional short term investment avenue to investors and to bring money market instruments within the reach of individuals.

The guidelines for MMMFs were announced by the Reserve Bank in April 1992. The Reserve Bank had made several modifications in the scheme to make it more flexible and attractive to banks and financial institutions. These guidelines were subsequently incorporated into the revised SEBI regulations. In October 1997, MMMFs were permitted to invest in rated corporate bonds and debentures with a residual maturity of up to one year, within the ceiling existing for Commercial Paper (CPs). The minimum

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lock-in period was also reduced gradually to 15 days, making the scheme more attractive to investors.

MMMFs have witnessed phenomenal growth over the period. As on May 31, 2011, the total assets under management of the MMMFs was placed at Rs.1,83,622 crore\(^{87}\), 25 per cent of the aggregate assets under management of the Mutual Funds.

In order to promote retail holding in government securities and broaden the investor base, Mutual Funds which invest exclusively in government securities, Gilt Funds, were introduced. The first Gilt Fund in India was set up in December 1998. However, Gilt Funds have registered moderate growth. As on May 31, 2011, the total assets under management of the Gilt Funds was placed at Rs.3,336 crore, 0.5 per cent of the aggregate assets under management of the Mutual Funds.

Mutual Funds occupy a large share of the primary market of Certificates of Deposit (CDs) and CPs. As on June 10, 2011\(^{88}\), the total holdings of Mutual Funds in CDs and CPs remained at Rs.2,95,164 crore (66 per cent of the aggregate outstanding) and Rs.82,951 crore (65 per cent of the aggregate outstanding) respectively. Mutual Funds have also provided substantial liquidity to the secondary market segments of CPs and CDs. Their increased activity in the secondary market corresponds to their growing portfolio of money market investments. During the last six months, MFs’ share in the daily turnover the secondary market of CDs and CPs stood at around 41 per cent and 46 per cent respectively.

The overnight segment of the money market has also benefitted from the participation of Mutual Funds. Their reliance on the collateralized segment of the overnight markets, viz. market repo and Collateralized Borrowing and Lending Operations (CBLO), for placement of their daily surplus liquidity enhanced the depth of the markets.

\(^{87}\) Mutual Funds and Market Development in India (Address by Dr. Subir Gokarn, Deputy Governor, Reserve Bank of India at the CII 7th Edition of Mutual Fund Summit 2011 on June 22, 2011 at Mumbai)


Last accessed May 2012.
By contrast, in the Government Securities market, the participation of Mutual Funds has not been very encouraging. Of the outstanding Government of India dated securities, the Mutual Funds held 0.9 per cent as at end December 2010, which dropped to 0.2 per cent as at end March 2011. The average holding of government securities by the Mutual Funds during the last two years remained at 0.6 per cent as against 38.7 per cent by the banks, 22.4 per cent by insurance companies, 8.9 per cent by PDs, 6.7 per cent by PFs, 3.1 per cent by corporate entities. During the current calendar year till end of May, the average share of Mutual Funds in the secondary G-Sec market remained at 5.8 per cent of the total traded volume. One possible reason for the lower level of participation of Mutual Funds in the G-Sec market is lack of investor interest in the gilt-oriented Mutual Funds due to significant interest rate risks.

2.3.3. Future Role and Regulatory Issues
There is a need for Mutual Funds, especially gilt funds, to complement the role of PDs in promoting retail holding in government securities. Mutual Funds are supposed to tap retail investors, who in turn, to the extent that they have long horizons, provide stability to the market. They also benefit small investors by providing them access to risk-free gilt edged securities.

The Mutual funds are allowed in India to participate in the Interest Rate Swap (IRS) market for the purpose of hedging their own balance sheet risks. However, their participation has remained quite muted. The IRS market, although very liquid, suffers from a low customer base of around 1 per cent. The Mutual Funds may increase the use of IRS for hedging their interest rate risk which would help in broadening and deepening of the IRS market.

Mutual Funds are also allowed by SEBI to trade on Interest Rate Futures (IRF). IRF contracts on 10-year notional coupon bonds were launched on NSE in August 2009. The product witnessed significant activity during the initial period, but liquidity tapered off subsequently. RBI has already issued guidelines for futures contracts on 91-day T-Bills,
which are expected to be introduced shortly. RBI is also considering introduction of IRF contracts on 2-year and 5-year G-Secs. If the reason for Mutual Funds not actively participating in the G-Sec market is the underlying interest rate risk, then they obviously should make use of the IRF to hedge their interest rate risk. Their active participation will give impetus to the development of the IRF market.

The launch of Credit Default Swap (CDS) is impending. The guidelines on introduction of plain vanilla OTC single-name CDS for corporate bonds in India would be effective from October 24, 2011. The Mutual Funds would be eligible to buy credit protection (buy CDS contracts) to hedge their underlying credit risk on corporate bonds. They would also be permitted as market-makers subject to their having strong financials and risk management capabilities as prescribed by SEBI and as and when permitted by the SEBI. It is expected that Mutual Funds’ participation will provide momentum to the CDS market.

A significant feature of MMMFs or liquid Mutual Funds in India is that they have been mainly catering to the short-term investment needs of institutional investors such as corporate and banks whose redemption requirements are large and simultaneous. As on March 31, 2011\(^9\), the investor profile of liquid funds was dominated by corporate (76.5 per cent) followed by Banks/FIs (17.1 per cent), HNIs (5.3 per cent). As a consequence, when the banking sector faces liquidity shortfall and withdraws its investment from liquid Mutual Funds, they collectively come under stress. This may lead to a sharp fall in banks’ fresh investment in liquid funds which, in turn, could intensify the pressure on those entities that receive investments from the liquid funds.

It may be recalled that during October-November 2008, RBI had to provide a special dispensation in the form of Term Repo facility of Rs.60,000 crores, under which banks could avail central bank funds to address the liquidity stress faced by Mutual Funds,

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\(^9\) Mutual Funds and Market Development in India (Address by Dr. Subir Gokarn, Deputy Governor, Reserve Bank of India at the CII 7th Edition of Mutual Fund Summit 2011 on June 22, 2011 at Mumbai)
NBFCs, HFCs. Banks were given an SLR exemption up to 1.5 per cent of NDTL to address this problem.

A related issue is the circularity of funds between the banking system and Mutual Funds. Banks invest in Mutual Funds and the Mutual Funds put large volume of funds back to the banking system through investments in CDs, lending in CBLO and Market Repos. Such circular flow of funds between banks and Mutual Funds has the potential for creating systemic instability in times of stress/liquidity crunch. Thus, banks could potentially face a large liquidity risk. In this connection, RBI had announced in the monetary policy on May 3, 2011 that the bank’s investment in debt oriented Mutual Funds to be capped at 10 per cent of net-worth as on March 31 of the previous year and banks would be given a period of six months to achieve this limit.

2.3.4. Mutual Funds and Inclusion

The role of Mutual Funds in promoting savings continues to be insignificant in India. Despite a long history, assets of Mutual Funds in India constitute less than 10 per cent of GDP. A cross-country comparison suggests that Mutual Funds are very popular all over the world. However, assets under them in India are relatively low as compared with other emerging market economies.

One of the major reasons for relatively low activity of Mutual Funds in India is that penetration, especially in the rural areas remains small. This is an important issue from the perspective of financial inclusion of low-income households in the formal financial system. It is generally perceived that Mutual Funds are popular mainly with the middle and high-income groups and have not been found to be an attractive investment avenue for the low-income groups.\textsuperscript{90} Thus, if the sector has to grow fast, it needs to devise appropriate schemes to attract the saving of low-income groups, especially in rural areas. This is the only way to ensure participation of all categories of investors in

\textsuperscript{90} Mutual Funds and Market Development in India (Address by Dr. Subir Gokarn, Deputy Governor, Reserve Bank of India at the CII 7th Edition of Mutual Fund Summit 2011 on June 22, 2011 at Mumbai)
the financial markets, which is crucial for sustained development, both of the financial sector and the economy as a whole.

2.4 INDIAN MUTUAL FUND INDUSTRY TOWARDS 2020 (Issues of Concern)

Performance of the industry has been strong in the past and it is well-placed to achieve sustainable growth levels for the future. The way forward for the next couple of years for the mutual fund industry would be influenced hugely by the journey undertaken till this point of time and the changing demographic profile of investors. As the future of Indian Mutual Fund Industry seems to be bright, we may come across the following expected developments leading towards year 2020:

Diverse Range of Products – It is strongly expected that in the years to come Indian Mutual Funds will come out with innovative products that will cater to the ever changing customer requirements. In other matured economies like United States, Mutual Funds provide products that cater to the entire life cycle of the investors. Diversified products keep the present momentum going for the industry in a more competitive and efficient manner. Further, Mutual Funds compete with bank deposits and government securities for their share of consumer savings. Similarly Indian Mutual Funds, in order to make them more acceptable to the retail investors, they would be mature enough to offer comprehensive life cycle financial planning to Indian investors in the time to come and not products alone.

Regulation for Mutual Fund Distributors – Currently, distributors of Mutual Fund schemes are not separately regulated by any authority in India. Further, many of them though certified by AMFI still leave a lot to be desired so as to render professional advice to investor and reduce mis-selling of the Mutual Fund products. Mutual Funds need distributors who are able to inform the investors about the efficacy of the product for a particular risk profile and stage in their life cycle. SEBI is currently planning to put in place a compliance certification examination (by NISM) and is expected to run it online from 2010-11. Further, SEBI is also expected to soon come out with a new set of guidelines for Mutual Fund distributors. As the affluence of Indians increase, the range of financial products to meet people’s need will expand and with it the need for professional financial advice from the Mutual Fund distributors will also increase.

Review of eligibility norms for AMCs – SEBI had constituted the “Committee on Review of Eligibility Norms” (CORE) to re-visit the eligibility norms and other functional aspects prescribed for various intermediaries. Amongst other recommendations, the key ones are relating to increase in the minimum net worth of AMCs from the existing Rs. 10 crores to Rs. 50 crores, change in the definition of net worth, sponsor to be a regulated entity and change in definition of control. The objective of the proposed
recommendations is to allow only the serious players to enter/remain in the market. The proposed changes can lead to a better governance of the Mutual Fund players, thereby boosting investor confidence in the industry in near future.

Trading through stock exchange platforms – Recently, SEBI has permitted trading of Mutual Fund units on recognized stock exchanges. Subsequently, Bombay Stock Exchange and National Stock Exchange have launched trading platforms enabling investors to invest by availing services of stock brokers. While trading through the stock exchange, the investor would get to know about the validity of his order and the value at which the units would get redeemed to his account by the end of the day. Whereas, while investing through Mutual Fund distributor or directly with the Mutual Fund, the investor gets information of the subscription and redemption details only in the form of direct communication from the AMC. Thus, by trading through the stock exchange, the investor would be able to optimize his investment decisions due to the reduced time lag in the movement of funds. This transparency in knowing the status of order till completion helps in reducing disputes. Further, the investor would able to get a single view of his portfolio across multiple assets like securities, Mutual Fund units etc.

Real Estate Mutual Funds – Real Estate Mutual Funds could be the next big thing for the Indian industry provided the regulators bring in more clarity on the tax and regulatory aspects. Asset Management Companies today need to stay focused on a few aspects in order to ensure that the industry meets its growth objectives. If everything goes well, very soon we will be witnessing the introduction and growth of real estate mutual funds in India.

2.5. CONCLUSION
Mutual Funds clearly have a significant role to play in the development of Indian economy. Their modus operandi of aggregating pools of saving from a large number of retail investors and deploying these resources in a variety of financial markets, based on
different risk-return preferences simultaneously enhances efficiency, stability and financial inclusion of different types of investors. It is also relatively easy for them to be transparent about both their strategies and outcomes.

Thus, if the government and market regulators give sufficient amount of attention to the Mutual Fund industry and nurture it for expansion in the time to come, the Indian Mutual industry will surely will become an integral part of the mechanism of transforming small savings of masses into great investment inflows for the economy.