CHAPTER – 3

OVERVIEW OF MUTUAL FUNDS

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3.1 Introduction

Economy of a country is highly influenced by its financial system which consists of financial intermediaries, financial markets, financial instruments and financial assets. The financial system facilitates transformation of savings of individuals, business and government into consumption and investment in the society. An efficient financial system is necessary for economic development of a country as it encourages savings and investment, allocates scarce resources to different productive channels and accelerates the rate of economic development. The role of financial intermediary helps to realize the opportunities for savings and real investments in the economy as a mediator between savers and borrowers. It also helps in eliminating market imperfections which arise due to non-availability of information about borrowers. An institutional set up of financial intermediaries is required to mobilize the savings of the society and investing rationally to make the economy conducive to further generation of savings and mobilization of resources at a subsequent stage. This requires a well-designed set-up of financial intermediaries to play a key role for the economic development of a country like India.

The financial intermediaries of the Indian financial system are Banks, Insurance Companies, LIC, Financial Institutions, Mutual Funds, Financial Companies, etc. The capital markets should be developed to prevent domination of banks in the intermediation process. The prudent development of a diversified financial system should be encouraged to promote economic growth and development as it also offers more checks and balances with respect to channelizing of funds from savers to investors. Our economy is under transition on account of liberalization and ongoing structural changes in the financial system and has undergone a radical change from state controlled and highly regulated to a market economy.

The objectives of the reforms were to remove the entry barriers for domestic private sector institutions and foreign institutions, increase transparency in market operations of financial intermediaries, exercise control by the principle of management by exception and promote environment for healthy competition. The reforms in the financial sector have enhanced the scope of access to international capital markets and the flow of international savings into our country for integrating the Indian markets.
with global capital markets. These changes often include negativity and shake the confidence of the investors in the capital market. There are large numbers of small investors who are keen to make investment in capital market but they lack professional expertise to face the bull and bear as they are unable to predict the market conditions. Mutual funds play a crucial role of mobilization of savings from investors and efficient allocation of resources in the economy.

Mutual funds are a synonym for an investment company in USA and an investment trust in UK and other European countries. It is a financial intermediary, which pools the savings of several individuals and invests the money thus raised in equity shares, debentures, bonds, government securities and other such instruments. An investor can invest either directly in securities or can invest through mutual funds. By investing through a mutual funds having professional expertise, the risk is reduced. Several authors have defined mutual funds in different words but meaning the same i.e. it is a non-banking financial intermediary who acts as “important vehicle for bringing wealth holders and deficit units tighter indirectly (Pierce, 1984).” The definition of mutual funds needs to be modified for our country as rightly quoted by Dr. J.C. Verma (1992), “Having taken into consideration the organizational structure of mutual funds, the definition is required to be re-casted, accordingly, mutual funds are trusts authored by sponsors to mobilize savings by selling units to public and investing the proceeds in corporate securities through asset management companies.”

3.2 Rationale for Mutual Funds

There are large numbers of small investors who have neither the professional expertise nor adequate funds to participate directly in the stock market operations as the capital markets are highly volatile and thinly traded. The entry of foreign institutional investors in our country as a result of liberalization and globalization, has contributed optimism and volatility to the Indian capital markets making it difficult for small investors to cope up with the complexities. The office of the controller of capital issues has been abolished in the wake of economic liberation which has provided freedom to the companies to fix the issue prices. Now, the companies are free to fix the prices of the shares based on the test of marketability instead of profitability and assets base criteria. Some of the companies which charged healthy

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premium on their equity issues, which are highly discounted now. The individual investors who subscribed the equity shares issued at high premium have lost their investments as the market prices are prevailing at very low rates.

The securities and exchange board of India was established in 1988 as a statutory and regulatory body “to protect the interests of the investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto (SEBI, 2011).” SEBI has also made it compulsory that equity shares of specified group should be dematerialized and can be traded through depositories. It has facilitated the institutional investors as they are trading in large volumes. Such shares can’t be traded in physical form by small investors.

If small investor is keen to participate in secondary market operation, he is required to open an account with a depository Participant (DP). The annual charge is Rs. 500 per account besides the account opening expenses. Even if they want to dispose-off the shares held by them at whatever prices prevailing in the market, they will have to open an account with a DP and it takes 25 to 30 days to get such shares converted into electronic or dematerialized form. The small investors neither can participate in secondary market nor can dispose-off their investments without dematerialization and opening of account with a DP, making it costly to them.

During the years 1990-95, there was a boom in the stock markets and large number of companies raised funds from public. The trading of listed shares at higher prices prompted many promotes and companies to raise funds through public issues. Many brokers and members of stock exchanges incorporated finance companies to raise funds from the public.

One of the objectives of the public issues used to be listing of the shares on the stock exchanges. Several companies raised funds from public and a large number of investors participated in the public issues. The shares of all such companies when listed used to be quoted at higher prices. This did not last long and the poor performing companies started to wind up their operation. As a result of poor performance and inexperienced promoters of first generation, many companies have
disappeared. Such companies have no assets, offices, plants, registered offices, etc. It is not certain who has gained but it is certain that the investors are the losers “Indian investors had to experience the wrath of many scams”. In each of these the only losers were investors. Be it the Harshad Mehta scam or the IPO boom of 1990s. Indian investors are accustomed to being the sacrificial goats (Rajeshwar, 1998).

During the last decade, many plantation companies floated investment schemes promising to reward the investors at very attractive rates of return. Besides the fixed rates of return ranging from 20 percent to 30 percent the plantation companies offered teak wood or a piece of land as terminal benefits. The value of teak or land as terminal benefits used to be 10 to 20 times of the investment amount. Such companies could attract the greedy investors as they were issuing postdated cheques for interest and principal amount with the deposit certificate and the terminal benefits in the form of teak wood or a piece of land were not guaranteed. The plantation companies could mobilize savings as no income-tax was payable by the investors on the regular fixed income and capital gains in the form of terminal benefits as income being agriculture income totally exempted from income tax.

SEBI being a regulatory authority failed to protect the interests of the investors and the investors had to suffer the losses as a result of scams. The impact of all these scams can be seen in the sagging state of the capital markets which refuse to revive and the stock prices are ruling at bottom.

Investors like returns and try to maximize returns by investing in equity shares and debentures or fixed income securities. “Return, however, is not the only consideration. If this were so, each investor would be holding in his portfolio a single security- one where the expected return is the highest, clearly, this is not so. Investors hold multiple securities in their portfolios. This is because, investors are risk-averse. They dislike risk. By including multiple securities in their portfolios, they expect to reduce risk” (Obaidulla, 1994).

It is clear that the investors require maximum returns and reduce the risk by diversification. By investing in equity shares or debentures through mutual funds, the
risk is reduced. It also meets both the objectives of investors to earn income and capital gains. There are several advantages of investing through mutual funds route in capital markets. The mutual funds undertake extensive research of economy, industry and companies and supervise them constantly. The professional fund manager will invest the funds or liquidate the investments at proper time which an individual investor can’t afford. They also provide liquidity by listing the closed-ended schemes on the stock exchanges and purchasing units of open ended schemes at Net Asset Value (NAV). The investors have freedom to enter and exit at any time. If investors invest in mutual funds, they can’t fall prey to misleading and motivating tips. Their investment in mutual funds is safe as the mutual funds are regulated by SEBI regulations.

There are several schemes of mutual funds which provides tax benefits. Equity Linked Saving Schemes (ELSS) provides income-tax benefits u/s 80C of the income tax Act, 1961 for investment made up to Rs. 100000 in a year along with other specified incomes. The operating cost can be reduced substantially by investing through mutual funds as they have large investible funds at their disposal. The brokerage fees or trading commission costs are reduced substantially. Mutual funds also provide investment services like reinvestment of dividends, systematic investment and withdrawal options and regular returns. They offer various schemes matching with the requirements of all categories investors.

We can conclude that the investors don’t get adequate returns for holding investments and managing their portfolios. “There is volatility, lack of liquidity, lack of skills for making right selections of stock and choosing timings to off-load the stocks. These factors have rendered investment by individuals in capital market instruments as a difficult task. Yet, stock market investing is tempting to investors because no other avenue can provide better return on investment as stock market.” Mutual funds is the right choice for small investors and there is no better alternative which can provide benefits of expertise and ability of investment research, take recourse tradeoff between the expected returns and its risks, etc. Dr. J. C. Verma has concluded that, “In the near future when the dust of financial reforms settles down, mutual funds will
remain the better avenues for small investors to invest their saving for better and safe returns.”

3.3 Concept of Mutual Funds
A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments and other securities. Mutual funds have a fund manager who invests the money on behalf of the investors by buying or selling stocks, bonds etc.

There are many reasons why investors prefer mutual funds. Buying shares directly from the market is one way of investing. But this requires spending time to find out the performance of the company whose share is being purchased, understanding the future business prospects of the company, finding out the track record of the promoters and the dividend, bonus issue history of the company etc. An investor needs to do research before investing. However, many investors find it cumbersome and time consuming to pore over so much of information, get access to so much of details before investing in the shares. Investors therefore prefer the mutual funds route. They invest in a mutual funds scheme which in turn takes the responsibility of investing in stocks and shares after due analysis and research. The investor need not bother with researching hundreds of stocks. It leaves it to the mutual funds and its professional fund management team.

Another reason why investor prefers mutual funds is because mutual funds offer diversification. An investor’s money is invested by the mutual fund in a variety of shares, bonds and other securities thus diversifying the investor portfolio across different companies and sectors. This diversification helps in reducing the overall risk of the portfolio. It is also less expensive to invest in a mutual funds since the minimum investment amount in mutual funds units is fairly low (Rs. 500 or so). With Rs. 500 an investor may be able to buy only a few stocks and not get the desired diversification.

Indians have been traditionally savers and invested money in traditional savings...
Instruments such as bank deposits. Against this background, if we look at approximately Rs. 700000 (AMFI, 2011) crores which Indian mutual funds are managing, then it is no mean an achievement. A country traditionally putting money in safe, risk-free investments like bank FDs, post office and life insurance. However, there is still a lot to be done. The Rs. 700000 crores stated above includes investments by the corporate sector as well. Going by various reports, not more than 5 percent of household savings are channelized into the markets, either directly or through the mutual funds route. Not all parts of the country are contributing equally into the mutual funds corpus. Eight cities account for over 60 percent of the total assets under management in mutual funds.

These are issues which need to be addressed jointly by all concerned with the mutual funds industry. Market dynamics are making industry players to look at smaller cities to increase penetration. Competition is ensuring that costs incurred in managing the funds are kept low and fund houses are trying to give more value for money by increasing operational efficiencies and cutting expenses. As of today there are around 44 Mutual funds in the country. Together they offer around 1051 schemes (AMFI, 2011) to the investor. Many more mutual funds are expected to enter India in the next few years.

All these developments will lead to far more participation by the retail investor and ample of job opportunities for young Indians in the mutual funds industry. Investors need to understand the nuances of mutual funds, the workings of various schemes before they invest, since their money is being invested in risky assets like stocks.

3.4 History of Mutual Funds
The history reveals that the main cause of evolution of mutual funds was to spread the risk. It had its formal origin in Belgium as an investment company to finance investments in national industries with high associated risks in 1822. The Foreign and Colonial Government Trust was established in England in 1868 to spread risks for investors over a large number of securities. The first mutual funds of the world, the Massachusetts Investors’ Trust was launched in Boston, USA in 1924. The number of
investment trusts and investment companies increased during the boom period and wiped out due to stock market crisis in European countries.

During the boom period, the investors considered stock market as an attractive investment but their investments were wiped out during recession. Hence, the small investors could not operate effectively in the market and this let to setting up of mutual funds in the form of investment companies.

Most of the investment companies established in the beginning were close ended and invested their funds in stock markets. The performance of these companies was closely linked to stock market booms and crashes. The open-ended investment companies were first organized in the USA and they were allowed to borrow money for investing in securities. This facility helped them to increase returns for their investors during favorable market conditions. But these investment companies in the USA, overboard in borrowing funds, and recklessly invested the borrowed funds in the stock market. The value of shares of these over leveraged companies got totally eroded when the market crashed in 1929.

After Second World War, the stock markets started to revive as a result of reconstruction in various countries. It also gave boost to mutual funds culture as people started investing in mutual funds. But the decline of stock market in 1970 made returns on mutual funds unattractive and investors started turning away from mutual funds. The returns in stock market and interest rates on demand deposits were low but the money market rates were reining at higher levels. This prompted the investors to divert their funds to money market from stock markets and banks. The mutual funds caught on to the trend and launched money market funds. The success of money market funds accelerated the setting-up of other kinds of innovative mutual funds like Fixed Income Funds, Tax-Exempt Funds, Bonds Funds, Index Funds, etc. It became the starting point for the development of the mutual funds industry as it is today offering various types of schemes matching with the requirements of different kinds of investors.
3.5 Evolution of Mutual Funds in India

The first investment trust, Financial Association of India and China, was formed in India in 1869 but the growth of investment trust business started after 1930. The Indian central banking enquiry committee expressed the need for unit trust type of institutions in its report submitted in 1931 that “an immeasurable benefit to India is bound to grow from the establishment and proper working of unit trusts, and the assistance which they will give to the investor in the creation of intermediate securities which do not exist, now in providing a channel for investment in industrial and other fields, where the primary investor would be too scared or too ignorant.”

The report highlighted immeasurable benefits to the investors from the proper working of mutual funds by creating intermediate securities in the form of units to channelize investments in industry and other fields as the investors were scared and ignorant. No action was taken by the British government to establish unit trust. Industrial investment trust was established in 1933 by Shri Premchand Roychand at Bombay. All the large industrial houses in the country followed him and transferred their surplus funds to such trusts formed under the companies act. These trusts working as investment companies mobilized funds from industrial group companies and the promoters of such companies. These investment companies failed to mobilize household savings and savings of small investors.

The committee on finance for private sector in India constituted in 1954, popularly known as Shroff committee, expressed the need for introducing unit trusts in the Indian capital market to increase the availability of capital for industries. The committee observed that unit trusts were suitable for mobilizing savings of small investors and suggested introduction of unit trusts in both public and private sectors.

The recommendations of Shroff committee and criticism on investment trusts by RBI stressed the need for an alternative to investment trusts to mobilize savings of small investors and increase the availability of capital for industries. The dual role of management as agents of unit holders and as managers of funds was highlighted by RBI criticism and both the roles were separated later when mutual funds were established.

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The foundation stone of mutual funds industry was laid down by the parliament in 1963 with the enactment of the unit trust of India act. The finance minister, Mr. T. T. Krishnamachari while introducing UTI bill in the parliament stated, “I would christen this attempt as an adventure in small savings and I am confident that we are embarking on this adventure with every hope of being successful.” He highlighted the role of UTI as “an opportunity for the middle and lower income groups to acquire without much difficulty, property in the form of shares.”

UTI was set up in 1963 as a statutory body and Mr. R.S. Bhatt (1996) was appointed as the founder chairman of unit trust of India. UTI launched its first open-ended scheme US-64 in 1964, ULIP in 1971, Unit Scheme for Charitable and Religious Trusts in 1981, Capital Gains Unit Scheme in 1983 and Children’s Gift Growth Fund Unit Scheme in 1986. India Fund Unit and Master Share Scheme were the first close-ended schemes launched by UTI in 1986.

The mutual funds industry in India started in 1963 with the formation of Unit Trust of India, at the initiative of the Reserve bank and the government of India. The objective was to attract the small investors and introduce them to market investments. Since then, the history of mutual funds in India can be broadly divided into six distinct phases. The graph indicates the growth of assets over the years.

**Chart 3.1 Assets Under Management (AUM) of Indian Mutual Funds Industry**

Source: - www. Amfiindia.com

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3.5.1 Phase – 1 – 1964-87: Growth of Unit Trust of India

In 1963, UTI was established by an act of parliament. As it was the only entity offering mutual funds in India, it enjoys monopoly. Operationally, UTI was set up by the RBI, but was later de-linked from the RBI. The first scheme, and for long one of the largest, launched by UTI was Unit Scheme 1964. Over the years, US-64 attracted the largest number of investors in any single investment scheme. It was also at least partially the first open-end scheme in the country.

Later in 1970s and 80s, UTI started innovating and offering different schemes to suit the needs of different classes of investors. Unit Linked Insurance Plan (ULIP) was launched in 1971. Six new schemes were introduced between 1981 and 1984. During 1984-87, new schemes such as Children’s Gift Growth Fund (1986) and Master Share (1987) were launched. Master share could be termed as the first diversified equity investment scheme in India. The first Indian offshore fund, India fund, was launched in August 1986. During 1990s, UTI catered to the demand for income oriented schemes by launching Monthly Income Schemes, a somewhat unusual mutual funds product offering “assumed returns”. In absolute terms, the investible funds corpus of UTI was about Rs. 600 crores in 1984. By 1987-88, assets under management of UTI had grown ten times to Rs. 6700 crores.

3.5.2 Phase 2 – 1987-1993: Entry of Public Sector Funds

1987 marked the entry of other public sector mutual funds. With the opening up of the economy, many public sector banks and financial institutions were allowed to establish mutual funds. State bank of India established the first non-UTI mutual funds- SBI Mutual funds – in November 1987. This was followed by canbank Mutual funds, LIC Mutual funds, Indian Bank Mutual funds, Bank of India Mutual funds, GIC Mutual funds and PNB Mutual funds. LIC launched LIC Dhanraksha, LIC Dhanvridhi and LIC Dhanshree schemes in 1989. These funds helped in enlarging the investor community and the investible funds. From 1987-88 to 1992-93, the assets under management increased from Rs. 6700 crores to Rs. 47004 crores, nearly seven times.
Table – 3.1 – Amount Mobilized by Public Sector Banks and UTI

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<td>Amount Mobilized (Rs. Crores)</td>
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<td>UTI</td>
<td>11057</td>
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<tr>
<td>Public Sector</td>
<td>1964</td>
</tr>
<tr>
<td>Total</td>
<td>13021</td>
</tr>
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</table>

*Source: AFMI Website*

During this period, investors showed a marked interest in mutual funds, allocating a larger part of their savings to investment in the funds. UTI was still the largest segment of the industry, with about 80 percent market share.

3.5.3 Phase – 3 – 1993-1996: Emergence of Private Funds

A new era in the mutual funds industry began in 1993 with the permission granted for the entry of private sector funds. This gave the Indian investors a broader choice of ‘fund families’ and increasing competition to the existing public sector funds. Quite significantly, foreign fund management companies were also allowed to operate mutual funds, most of them coming into India through their joint ventures with Indian promoters. These private funds have brought in with them the latest product innovations, investment management techniques and investor servicing technology that make the Indian mutual funds industry today a vibrant and growing financial intermediary.

During 1993-94, five private sector mutual funds launched their schemes followed by six others in 1994-95. Initially, mobilization of funds by the private mutual funds was slow. But, this segment of the fund industry began to witness much greater investor confidence in due course. One influencing factor was the development of SEBI’s regulatory framework for the Indian mutual funds industry. Yet another important factor has been the steadily improving performance of several fund houses. Investors in India now clearly saw the benefits of investing through mutual funds and became discerning and selective. Kothari Pioneer mutual funds was the first private sector mutual funds followed by ICICI, BIRLA, Morgan Stanley, Taurus etc.
3.5.4 Phase – 4 – 1996-1999: Growth and SEBI Regulations

Since 1996, the mutual funds industry in India saw tighter regulation and higher growth. It scaled new heights in terms of mobilization of funds and number of players. Deregulation and liberalization of the Indian economy had introduced competition and provided impetus to the growth of the industry. Finally, most investor small or large started showing interest in mutual funds.

Measures were taken both by SEBI to protect the investor and by the government to enhance investors’ returns through tax benefits. A comprehensive set of regulations for mutual funds operating in India was introduced with SEBI (Mutual funds) Regulations, 1996. These regulations set uniform standards for all funds. The erstwhile UTI voluntarily adopted SEBI guidelines for its new schemes. Similarly, the budget of Union Government in 1999 took a big step in exempting all mutual funds dividends from income tax in the hands of investors. Both the 1996 regulations and the 1999 budget must be considered of historic importance, given their far-reaching impact on the fund industry.

During this phase, both SEBI and AMFI launched investor awareness programs aimed at educating the investors about investing through mutual funds. AMFI published its booklet titled “Making Mutual funds Work For You – The Investors’ Guide.”

3.5.5 Phase – 5 – 1999 – 2004: Emergence of Large and Uniform Industry

The other major development in the fund industry has been the creation of a level playing field for all mutual funds operating in India. This happened in February 2003, when the UTI act was repealed. Unit trust of India no longer has a special legal status as a trust established by an act of parliament. Instead, it has also adopted the same structure as any other fund in India – a Trust and an asset management company. UTI mutual funds is the present name of the erstwhile unit trust of India. While UTI functioned under a separate law of Indian parliament earlier, UTI mutual funds is now under the SEBI’s Mutual funds Regulations, 1996 like all other mutual funds in India.
UTI mutual funds is still the largest player in the Indian fund industry. All SEBI compliant schemes of the erstwhile UTI are under its charge. All new schemes offered by UTI mutual funds are SEBI approved. Other schemes (US 64, Assured Return Schemes) of erstwhile UTI have been placed with a special undertaking administered by the government of India. These schemes are being gradually wound up. The emergence of a uniform industry with the same structure, operations and regulations makes it easier for distributors and investors to deal with any fund house in India.

3.5.6 Phase – 6 – from 2004 onwards: Consolidation and Growth

The industry has lately witnessed a spate of mergers and acquisitions, most recent ones being the acquisition of schemes of Alliance mutual funds by Birla Sun Life, Sun F&C mutual funds by Principal and PNB mutual funds by Principal. At the same time, more international players continue to enter India, including Fidelity, one of the largest funds in the world. The stage is set now for growth through consolidation and entry of new international and private sector players. At the end of March 2006, there were 29 funds.

3.6 Classification of Mutual Funds

There are many types of schemes of mutual funds available to the Indian investor. However, these different types of schemes can be grouped into certain classifications for better understanding. From the investors’ perspective; researcher has followed three basic classifications.

Firstly, schemes are usually classified in accordance with their structure – as closed-end or open-end. The distinction depends upon whether they give the investors the option to redeem and buy units at any time from the fund itself or whether the investors have to wait till maturity before they can redeem their units to the fund. Closed-end funds are listed on stock exchanges. It may be noted that in the USA, all mutual funds are open-ended.

Schemes can also be grouped in terms of whether the fund collect from investors any charges at the time of entry or exit or both, thus reducing the investible amount or the redemption proceeds. Funds or schemes that makes these charges are classified as...
load funds, and funds or schemes that do not make any of these charges are termed no load funds.

In USA, schemes are also be classified as being tax exempt or non-tax exempt, depending on whether they invest in securities that give tax exempt returns or not. In Indian mutual funds industry we do not have such classifications.

Under each broad classification, we may then distinguish between several types of funds or schemes on the basis of the composition of their portfolios. A mutual funds has a unique risk profile that is determined by its portfolio. Therefore, mutual funds could span a wide range of investment risk.

3.6.1 Broad Classification of Mutual Funds
3.6.1.1 Open-End vs. Close-End Funds
An open end fund is one that sells and repurchases units at all times. When the fund sells units, the investor buys them from the fund. When the investor redeems the units, the fund repurchases the units from the investor. An investor can buy units or redeem units from the fund itself at a price based on the net asset value per unit. NAV per unit is obtained by dividing the amount of the market value of the fund’s assets by the number of units outstanding. The number of units outstanding goes up or down every time the fund sells new units or repurchases existing units. In other words, the unit capital of an open end mutual funds is not fixed but variable. When sale of units exceeds repurchase, the fund increase in size. When repurchase exceeds sale, the fund shrinks.

In practice, an open end fund is not obliged to keep selling new units at all times, though it has the obligation to repurchase units tendered by the investor. Many successful funds, if they think they cannot manage a large fund without adversely affecting profitability, stop accepting further subscriptions from new investors after they reach a certain size. As indicated earlier, an open end fund rarely denies its investors the facility to redeem existing units.
Unlike an open end fund, the unit capital of a close end fund is fixed, as it makes a onetime sale of a fixed number of units. After the offer closes, closed end funds do not allow investors to buy or redeem units directly from the funds. However, to provide the much needed liquidity to investor closed end funds list on a stock exchange. Trading through a stock exchange enables investor to buy or sell units of a closed end mutual funds from each other, through a stockbroker, in the same fashion as buying or selling shares of a company. The fund’s units may be traded at discount or premium to NAV based on investors’ perceptions about the funds future performance and other market factors affecting the demand for or supply of the funds units. The number of outstanding units of a closed end fund does not vary on account of trading in the funds units at the stock exchange. Sometimes, close ended funds do offer buy back of funds, thus offering another avenue for liquidity to closed end fund investors. In this case, mutual funds actually reduces the number of outstanding units. In India, SEBI regulations ensure that the closed end scheme investors are given at least one of the two exit avenues.

### 3.6.1.2 Load and No-Load Funds

Marketing of a new mutual funds scheme involves initial expenses. These expenses may be recovered from the investors in different ways at different times. Three usual ways in which funds marketing expenses may be recovered from the investors are:

- At the time of investor’s entry into the fund/scheme, by deducting a specific amount from his contribution
- By charging the fund/scheme with a fixed amount each year, during a specified number of years
- At the time of investors’ exit from the fund/scheme, by deducting a specified amount from the redemption proceeds payable to the investors.

These charges imposed on the investors to cover distribution/sales/marketing expenses are often called loads. The load charged to the investor at the time of his entry into a scheme is called “front-end load or entry load”. The load amount charged to the scheme over a period of time is called a “deferred load”. The load that the investor pays at the time of his exit is called a “back end load or exit load”. Some funds may also charge different amount of loads to the investors, depending upon how
many years the investor has stayed with fund, the long the investor stays with the fund, less the amount of exit load he is charged. This is called “contingent deferred sales charge”.

Funds that charge a front end load would be load funds as per SEBI definition. This is in line with the internationally used definition. However, SEBI would consider a fund to be a no-load fund, if an AMC absorbs these initial marketing expenses and does not charge the fund – a situation that is somewhat special to India and not widely prevalent elsewhere. Internationally, a fund even when it does not make a front end load would still be considered a load fund, if it charges an exit load or a deferred sales load.

The reason for this slightly different definition of a load by SEBI is to be found in the nature of its regulations. Front end load, or load as defined by SEBI, is meant to cover the marketing expenses associated with the first issue of a scheme. Other expenses are defined as recurring expenses, rather than as loads. SEBI regulations allow AMCs to recover loads from the investors for the purpose of paying for the initial issue expenses, subject however to a limit on the maximum amount that can be charged by the AMC. This limit currently stands at 6 percent, meaning that initial issue expenses should not exceed 6 percent of the initial corpus mobilized during the initial offer period. Similarly, SEBI has also imposed a limit on the maximum recurring expense that can be charged to a scheme. The limit has been related to the level of the daily or weekly average net assets. Thus, the AMC can charge a scheme 2.5 percent of the average net assets of the scheme as recurring expenses, if the net assets do not exceed Rs. 100 crores, 2.25 percent on the next 300 crores, 2.00 percent on the next 300 crores and 1.75 percent over Rs. 700 crores. If the AMC had absorbed the initial issue expenses, it can charge an additional 1 percent of net assets as recurring expenses. In case of closed end scheme these shall be lesser by at least 0.25 percent.

From the investor’s perspective, it is important to note that loads are not charged only by open end funds; even a close end fund can charge a load to cover the initial issue expenses. It is also important to note that there are other expenses such as the fund manager’s fees, which are charged to the investors on an ongoing basis. Such
expenses reduce the NAV of the fund. If the investor’s objective is to get the benefit of compounding his initial investment by reinvesting and holding his investment for a very long term, then a no-front load is preferable. The number of units allotted to an investor is based on the purchase price offered to him. In a no front end load fund, the NAV based purchase price offered to the investor is same as the fund NAV per unit, there being no deduction from the amount paid by him.

3.6.1.3 Tax Exempt vs. Non Tax Exempt Funds

Generally, when a fund invests in tax exempt securities, it is called a tax exempt fund. In the USA, municipal bonds pay interest that is tax free, while interest on corporate and other bonds is taxable. In India, any income received by the mutual funds is tax free. After the 1999 union government budget, all of the dividend income received from any of the mutual funds is tax free in the hands of the investor. However, funds other than open end equity oriented funds have to pay a distribution tax, before distributing income to investors. In other words, open end equity oriented mutual funds schemes are tax exempt investment avenues, while other funds are taxable for distributable income.

For the Indian mutual funds investor, both the dividends and long term capital gains from their fund investment are currently tax free. However, any short term capital gains arising out of repurchase of fund units are taxable. Further, after the 2005 union budget, repurchase transactions under equity oriented funds/schemes have been subjected to a security transaction tax. All these tax considerations are important in the investment decision. Hence, classification of mutual funds from the taxability perspective has great significance for investors.
3.6.2 Mutual Funds Types

All mutual funds would be either close ended or open ended or either load or no load. These classifications are general. Once reviewed the fund classes, it is required to discuss more specified fund types. Funds are generally distinguished from each other by their investment objectives and types of securities they invest in. Generally following are the major types of mutual funds that are available under the general classifications as discussed above. It may be noted some of the following fund types are not yet available or popular in India at present.

3.6.2.1 Broad Fund Types by Nature of Investment

Mutual funds may invest in equities, bonds or other fixed income securities, or short term money market securities. In this category mutual funds can be classified as Equity, Bond and Money Market or Liquid Funds. All these invest in financial assets. But here are mutual funds that invest in physical assets like Gold Funds, Precious Metals Funds or Real Estate Funds.

3.6.2.2 Broad Funds Types by Investment Objectives

Investors pursue different objectives while investing. Thus, Growth Funds invest for medium to long term capital appreciation. Income funds invest to generate regular income and less for capital appreciation. Value Funds invest in equities that are considered undervalued today, whose value will be unlocked in the future.

3.6.2.3 Broad Funds Types by Risk Profile

The nature of a fund’s portfolio and its investment objective imply different levels of risk undertaken. Funds are, therefore often grouped in order of risk. Thus, equity funds have a greater risk of capital less than a debt fund that seeks to protect the capital while looking for income. Liquid funds are exposed to less risk than even the bond funds, since they invest in short term fixed income securities, as compared to longer term portfolios of bond funds. In detail mutual funds can be classified as follows.
3.6.2.3.a - Money Market / Liquid Funds

Often considered to be at the lowest in the order of risk level, liquid funds invest in debt securities of a short term nature, which generally means securities of less than one year maturity. The typical short term interest bearing instruments includes treasury bills issued by governments, certificate of deposit issued by banks and commercial paper issued by companies. The major strengths of money market or liquid funds are liquidity and safety of the principal that investors can normally expect from short term investments. Though interest rate risk is present, the impact is low as the investment instruments’ maturities are short.

3.6.2.3.b - Gilt Funds

Gilts are government securities with medium to long term maturities, typically of over one year. In India, we have government securities or gilt funds that invest in government paper called dated securities. Since the issuer is the government of India, these funds have little risk of default and hence offer better protection of principal. However, Gilt securities, like all debt securities, face interest rate risk. Debt securities’ prices fall when interest rate levels increase. Investors have to understand the potential charges in NAVs of gilt funds of changes in interest rates in the economy.

3.6.2.3.c - Debt Fund or Income Funds

Next in the order of risk level is debt funds. Debt funds invest in debt instruments issued not only by government, but also by private companies, banks and financial institutions and other entities such as infrastructure companies. By investing in debt, these funds target low risk and stable income for the investor as their key objectives. However, as compared to the money market, they do have a higher price fluctuation risk, since they invest in longer term securities. Similarly, as compared to gilt funds, general debt funds do have a higher risk of default by their borrowers.

Debt funds are largely considered as income funds as they invest primarily in fixed income generating debt instruments. They do not target capital appreciation but look for current income, and therefore distribute a substantial part of their surplus to
investors. Income funds that target high returns can face more risks. Even within the broad category of debt investment, different investment objectives can be set. Each would result in a different risk profile. Following are the debt funds in this light.

### 3.6.2.3.c-i - Diversified Debt Funds

A debt fund that invests in all available types of debt securities, issued by entities across all industries and sectors is a properly diversified debt fund. While debt funds offer high income and less risk than equity funds, investor need to recognize that debt securities are subject to risk of default by the issuer on payment of interest or principal. A diversified debt fund has the benefit of risk reduction through diversification. Hence a diversified debt fund is less risky than a narrow focus fund that lead to risk reduction for the individual investor as any losses by a debt issuer are shared by a large number of investors in the fund.

### 3.6.2.3.c-ii - Focused Debt Funds

Some debt funds have a narrower focus, with less diversification in its investments. Example includes sector, specialized and offshore debt funds. They have a substantial part of their portfolio invested in debt instrument and are therefore more income oriented and inherently less risky than equity funds. However, the Indian financial markets have demonstrated that debt funds should not be automatically considered to be less risky than equity funds, as there have been relatively large defaults by issuers of debt and many funds have nonperforming assets in their debt portfolios. It should also be recognized that market value of debt securities will also fluctuate more as Indian debt market witness more trading and interest rate volatility in the future. The central point to note is that all these narrow focus funds have greater risk than diversified debt funds.

Other examples of focused funds include those that invest only in corporate debentures and bonds or only in tax free infrastructure or municipal bonds. While these funds are entirely conceivable now, they may take some time to appear as a real choice for the Indian investor. One category of specialized funds that invests in the housing sector, but offers greater security and safety than other debt instruments, is the mortgage backed bonds funds that invest in special securities created after
securitization of loan receivables of housing finance companies. As the Indian financial markets witness the growth of securitization, such funds may appear on the mutual funds scene soon.

3.6.2.3.c-iii - High Yield Debt Funds

Usually, debt funds control the default risk by investing in securities issued by borrowers who are rated by credit rating agencies and are considered to be of investment grade. There are, however, high yield debt funds that see to obtain higher interest returns by investing in debt instruments that are considered below investment grade. Clearly, these funds are exposed to higher default risk. In USA funds that invest in debt instruments are not backed by tangible assets and rated below investment grade are called junk bond funds. These funds tend to be more volatile than other debt funds, although they may earn at times higher returns as a result of the higher risk taken.

3.6.2.3.c-iv - Assured Return Funds – An Indian Variant

Fundamentally, mutual funds hold assets in trust for investors. All returns and risks are assumed by the investor. The role of the fund manager is to provide professional management service and to ensure the most favorable risk return profile consistent with the investment objective of the fund. The fund manager, the trustees or the sponsors do not guarantee minimum return to the investors.

However in India, historically, UTI and other funds had offered assured return schemes to investors. The most popular variant of such schemes was the monthly income plans of UTI. Returns were indicated in advance for all of the future years of these closed end schemes. In assured return schemes the shortfall, if any, is borne by the sponsors or AMCs. Assured return or guaranteed monthly income plans are essentially debt or income funds. Assured return debt funds certainly reduce the risk to the investor as compared to all other debt or equity funds, but only to the extent that the guarantor has the required financial strength. Hence, the market regulator SEBI permits only those funds whose sponsors have adequate net-worth to offer assurance of returns.
3.6.2.3.c-v - Fixed Term Plan Series – Another Indian Variant

A mutual funds scheme would normally be either open end or closed end. However, in India, mutual funds have developed an innovative middle option between the two, in response to investor needs. If a scheme is open ended, the fund issues new units and redeems them at all times. The fund does not have a stated maturity of fixed term of investment as such. Fixed term plan series offer combination of both these features to investors, as a series of plans are offered and units are issued at frequent intervals for short plan durations.

Fixed term plans are essentially closed end in nature, in that the mutual funds AMC issues a fixed number of units for each series only once and closes the issue after an initial offering period, like a closed end scheme offering. However, a closed end scheme would normally make a one-time initial offering of units, for a fixed duration generally exceeding one year. Investors have to hold the units until the end of the stated duration, or sell them on a stock exchange if listed. Fixed term plans are closed end, but usually for shorter term less than a year. Being of short duration, they are not listed on a stock exchange.

The scheme under which such fixed term plan series are offered is likely to be an income scheme, since the objective is clearly for the AMC to attempt to reward investors with an expected return within a short period. Mutual funds AMCs in India usually offering such plans do not guarantee any returns, but the product has clearly been designed to attract the short term investor who would otherwise place the money as fixed term bank deposits or inter corporate deposits.

3.6.2.3.d - Equity Funds

As investors move from debt fund category to equity funds face increased risk. However, there is a large variety of equity funds each with a slightly different risk profile. Investors and their advisors need to sort out and select the right equity fund that suits their risk appetite. In the following section various types of equity funds going from the highest risk to lowest risk in this category have been presented.
3.6.2.3.d-i - Aggressive Growth Funds
There are many types of stocks or shares available in the market: Blue Chips that are recognized market leader, less researched stocks that are considered to have future growth potential, and even some speculative stocks of somewhat unknown issuers. Fund managers seek out and invest in different types of stocks in line with their own perception of potential returns and appetite for risk. As the name suggests, aggressive growth funds target maximum capital appreciation, invest in less researched or speculative shares and may adopt speculative investment strategies to attain their objective of high returns for the investors. Consequently, they tend to be more volatile and riskier than other funds.

3.6.2.3.d-ii - Growth Funds
Growth funds invest in companies whose earnings are expected to rise than above average rate. These companies may be operating in sectors like technology considered having a growth potential, but not entirely unproven and speculative. The primary objective of growth fund is capital appreciation over a three to five year span. Growth funds are therefore less volatile than funds that target aggressive growth.

3.6.2.3.d-iii - Specially Funds
These funds have a narrow portfolio orientation and invest in only companies that meet predefined criteria. For example, at the height of the South African apartheid regime, many funds in the US offered plans that promised not to invest in South African companies. Some funds may build portfolios that will exclude tobacco companies. Funds that invest in particular regions such as the Middle East or the ASIAN countries are also an example of specialty fund. Within the specialty funds category, some funds may be broad based in terms of the types of investment in the portfolio. However, most specialty funds tend to be concentrated funds, since diversification is limited to one type of investment. Clearly, concentrated specialty funds tend to be more volatile than diversified funds.
3.6.2.3.d-iv - Sector Funds
Sector funds portfolio consist of investments in only one industry or sector of the market such as information technology, pharmaceuticals or fast moving consumer goods. Since sector funds do not diversify into multiple sectors, they carry a higher level of sector and company specific risk than diversified equity funds.

3.6.2.3.d-v - Foreign Securities Funds
These funds invest in equities in one or more foreign counties thereby achieving diversification across the country’s borders. However they also have additional risks such as the foreign exchange rate risk and their performance depends on the economic conditions of the countries they invest in. Foreign securities equity funds may invest in a single country or many countries hence more diversified.

3.6.2.3.d-vi - Mid-Cap or Small-Cap Equity Funds
These funds invest in shares of companies with relatively lower market capitalization than big blue chip companies. They may thus be more volatile than other funds, as mid-size or smaller companies’ shares are not very liquid in the market. Investor can think of these funds as a segment of specialty funds. In terms of risk characteristics, small company funds may be aggressive growth or just growth type.

3.6.2.3.d-vii - Option Income Funds
These funds do not yet exist in India, but option income funds write options on a significant part of their portfolio. While options are viewed as risky instrument, they may actually help to control volatility, if properly used. Conservative option funds invest in large, dividend paying companies, and then sell options against their stock positions. This ensures a stable income stream in the form of premium income through selling options and dividends. Now that options on individual shares have become available in India, such funds may be introduced.

3.6.2.3.d-viii - Diversified Equity Funds
A fund that seeks to invest only in equities, except for a very small portion in liquid money market securities, but is not focused on any one or few sectors or shares, may be termed as diversified equity fund. While exposed to all equity price risks,
diversified equity funds seek to reduce the sector or stock specific risks through diversification. They have exposure to the equity market risk. Such general purpose diversified funds are clearly at a lower risk level than growth funds.

3.6.2.3.d-ix - Equity Linked Savings Schemes: An Indian Variant
In India, investors have been given tax concessions to encourage them to invest in equity markets through these special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but usually has a lock in period. As the name suggests, there are no specific restrictions on the investment objectives for the fund managers. Investors should clearly look for where the fund management company proposes to invest and accordingly judge the level of risk involved. Generally, such funds would be in the diversified equity fund category.

3.6.2.3.d-x - Equity Index Funds
An index fund tracks the performance of a specific stock market index. The objective is to match the performance of the stock market by tracking an index that represents the overall market. The fund invests in shares that constitute the index and in the same proportion as the index. These funds take only the overall market risk, while reducing the sector and stock specific risks through diversification. However, there are index funds that track a narrow sectorial index, such as pharmaceutical index or bank index. These will be less diversified and more risky, although they will still be less risky compared to individual stocks in the sector or industry.

3.6.2.3.d-xi - Value Funds
The growth funds reviewed above hold shares of companies with good or improving profit prospects, and aim primarily at capital appreciation. They concentrate on future growth prospects, may be willing to pay high price multiples for companies considered to have high growth potential. In contrast to the growth investing, some funds follow value investing approach. Value funds try to seek out fundamentally sound companies whose shares are currently under priced in the market. Value funds will add only those shares to their portfolios that are selling at low price earnings ratios, low market to book value ratios and are believed to be undervalued compared to their true potential. Value funds take equity market risks, but stand often at a lower
end of the risk spectrum in comparison with the growth funds. Value stocks may be from a larger number of sectors and therefore diversified. In the long term, value funds ought to be less risky than growth funds or even equity diversified funds.

3.6.2.3.e - Hybrid Funds – Quasi Equity/Quasi Debt
In terms of the nature of financial securities held, there are three major mutual funds types: money market, debt and equity. Many mutual funds mix these different types of securities in their portfolios. Thus, most funds, equity or debt, always have some money market securities in their portfolios as these securities offer the much needed liquidity. However, money market holdings will constitute a lower proportion in the overall portfolios of debt or equity funds. There are funds that, however, seek to have a relatively balanced holding of debt and equity securities in their portfolios. Such funds are termed hybrid funds as they have a dual equity bond focus. Some of the funds in this category are described below.

3.6.2.3.e-i - Balanced Funds
A balanced fund is one that has a portfolio comprising debt instruments, convertible securities, preference and equity shares. Their assets are generally held in more or less equal proportions between debt or money market securities and equities. By investing in a mix of this nature, balanced funds seek to attain the objectives of income, moderate capital appreciation and preservation of capital, and are ideal for investors with a conservative and long term orientation.

3.6.2.3.e-ii - Growth and Income Funds
Unlike income focused or growth focused funds, these funds seek to strike a balance between capital appreciation and income for the investor. Their portfolios are a mix between companies with good dividend paying records and those with potential for capital appreciation. These funds would be less risky than pure growth funds, though more risky than income funds.
3.6.2.3.e-iii - Asset Allocation Funds

Normally, an equity fund would have its primary portfolio in equities most of the time. That is, the assets are primarily equity holding. Similarly, a debt fund would have allocated much of its money to debt instruments. The proportion of money to be invested in a particular class of asset is predefined. In other words, their asset allocation is predetermined to a large extent. However, there do exist funds that follow variable asset allocation policies and move in and out of an asset class depending upon their outlook for specific markets. The fund manager is given the flexibility to shift towards equity when equity market is expected to do well and to shift towards debt when the debt market is expected to do well. The success of such strategy would depend on the skill of the fund manager in anticipating market trends. For the reason, asset allocation funds could be riskier.

3.6.2.3.f - Commodity Funds

While all of the debt, equity or liquid funds invest in financial assets, the mutual funds vehicle is suited for investment in any other, for example physical assets. Commodity funds specialize in investing in different commodities directly or through shares of commodity companies or through commodity futures contracts. Specialized funds may invest in a single commodity or a commodity group such as edible oils or grains, while diversified commodity funds will spread their assets over many commodities.

A most common example of commodity fund is the so called precious metal funds. Gold funds invest in gold; other precious metals funds such as platinum or silver are also available in other countries. They may take exposure to more than one metal to get some benefits of diversification. In India, the union finance minister recently announced a gold linked unit scheme like gold fund. These schemes hold a good potential, given the large public holding and interest in gold. Similarly, a large number of commodity futures contracts are now available for trading on commodity exchanges, making it possible to launch commodity funds.
3.6.2.3.g - Real Estate Funds
Specialized real estate funds would invest in real estate directly, or may fund real estate developers, or lend to them, or buy shares of housing finance companies or may even buy their securitized assets. The funds may have a growth orientation or seek to give investors regular income.

3.6.2.3.h - Exchange Traded Funds
An exchange traded fund is a mutual funds scheme, which combines the best features of open end and closed end structures. It tracks a market index and trades like a single stock on the stock exchange. Its pricing is linked to the index and units can be bought or sold on the stock exchange. ETF offers investor the benefit of flexibility of holding single shares well as the diversification and cost efficiency of an index. These funds are popular abroad and have recently been introduced in India.

Although based on an index, ETFs should not be confused with index funds. Investors can buy index funds units directly from the asset management company at a unique net asset value that will be applicable to all investors. ETFs trade on the exchanges and thus its unit price is determined in the market place and will keep changing from time to time. ETFs are bought and sold through intermediaries who are generally market makers buying and selling the units with two way price quotes. These market makers allow investors to exchange ETF units for underlying shares. This is not possible in the case of index mutual funds.

Fund distributors should note that ETF AMCs usually do not pay any commissions to intermediaries, not recover any loads from investors. Market makers keep their margin in the form of difference in bid and ask prices. For the investor, therefore, ETFs are less costly and more efficient in terms of tracking the index performance. They can even ask for delivery of underlying shares.

3.6.2.3.i - Fund of Funds
A fund of funds invests in other mutual funds. Just as a normal mutual fund invests in a portfolio of securities such as debt or equity, a fund of funds invests in a portfolio of

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the units of other mutual funds schemes. Availability of a fund of funds to an investor helps him select the right funds from a wide variety of schemes offered by different asset management companies. It also helps the investor diversify his risk not only in terms of the types of securities held in the portfolio, but also in terms of schemes of different fund managers and investment styles, for example, a fund of funds can invest in top performing equity funds of different AMCs and offer the most widely diversified portfolio to the investor. It can also invest in equity and income schemes of other AMCs simultaneously offering the investor balanced or diversified portfolios across asset classes.

The risk level associated with this type of fund is generally lower than that of conventional mutual funds schemes. Investor in such funds also enjoys the advantage of diverse management styles. A fund of funds could, however, result in higher expenses as the expenses of the AMC that manages the fund of funds get added to the expenses of the other schemes it invests in.

3.6.2.4 Risk Apatite and Difference Types of Mutual Funds

It must be appreciated that no specific class or type is universally accepted as the best option. Each type of fund comes with its pros and cons and a unique risk return relationship. It is up to the investor to decide the type that best suits his requirements and matches his objectives.
Figure - 3.1 - Risk Apatite and Different Types of Mutual Funds

- Aggressive Growth Funds
- Flexible Asset Allocation Funds
- High Yield Debt Funds
- Gilt Funds
- Money Market Funds
- Balanced Funds
- Diversified Debt Funds
- Diversified Equity Funds
- Equity Income Funds
- Growth and Income Funds
- Growth Funds
- Index Fund
- Value Funds
- Focused Debt Funds
- Equit Equity Funds
- Index Fund
3.7 Structure of Indian Mutual Funds

A mutual funds is set up in the form of a trust, which has sponsor, trustees, asset management company (“AMC”) and a custodian. The trust is established by a sponsor or more than one sponsor who is like a promoter of a company. The trustees of the mutual funds hold its property for the benefit of the unit-holders. The AMC, approved by SEBI, manages the funds by making investments in various types of securities. The custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI regulations by the mutual funds.

**Figure – 3.2 - Structure of Indian Mutual Funds**

- **Sponsor Company**
  - Managed by a Board of Trustee
  - Appointed by Board of Trustee

- **Mutual Funds**
  - Appointed by Trustee
  - Appointed by Trustee
  - Appointed by Trustee

- **Asset Management Company**
  - Held Unit holders Fund in MF Ensure Compliance to SEBI Enter into Agreement With SEBI

- **Custodian**
  - Provides Necessary Custodian Service
  - Bankers

- **Registered Transfer Agents**
  - Provide Registrars Service and Act as a Transfer Agents

- **Establishes MF as a Trust Register MF with SEBI**
  - SEBI

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3.8 Regulatory Framework of Mutual Funds

The mutual funds act should make provisions for the constitution, organization, management, investment objectives, pricing of units for sale and purchase, disclosure, protection of interests of investors, responsibilities of all constituents, legal obligations of all parties to mutual funds, income distribution, accounting and auditing norms, mergers and acquisition of mutual funds, winding up of mutual funds, etc. The detailed provisions on all these aspects are essential to eliminate chances of manipulation and frauds for personal benefits causing harm to the innocent investors and to maintain confidence and faith of public.

The following laws regulate the mutual funds industry in our country.
2. The Indian Trusts Act, 1882.
4. SEBI (Mutual Funds) Regulations, 1996.
5. Guidelines of the Central Government, RBI & SEBI.

UTI, constituted under the unit trust of India act, 1963, is a central government undertaking and falls within the territory of the central government control. All other mutual funds are regulated by the SEBI (mutual funds) Regulations, 1996 except money market and off shore mutual funds which are regulated by the reserve bank of India guidelines. The pattern of organization depends upon regulations pertaining to these categories of mutual funds. All mutual funds in our country have two types of organization structures, one is represented by the unit trust of India having statutory status under the UTI act, 1963 and the other type of organization structure is followed by private and public sector mutual funds registered under SEBI and regulated by SEBI (mutual funds) regulations, 1996.

“In developed countries like UK and USA the mutual funds industry is highly regulated with a view to impact organizational transparency and protects investors’ interests. Since there is a clear distinction between open-ended schemes and close ended schemes, usually two different types of structural and management approaches are followed. Open ended funds (unit trusts), in the UK follow the “trust approach”

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while close-ended schemes (investment trusts) follow the “corporate approach”. The management and operations of such funds are therefore guided by separate regulatory mechanisms, and rules are laid down by the separate controlling authorities. However, these distinctions are not followed in India and both the approaches have been integrated by the Indian regulatory authority; SEBI (Sadhak, 1991). The recommendations of the Shroff Committee, and the criticism on investment trusts by the Reserve bank of India stressed the need for an alternative to investment trusts. This led to setting up of unit trust of India under the unit trust of India act, 1963.

The savings instruments issued by post offices are guaranteed by the government of India, deposits of banks are protected by capital adequacy and insurance, debenture holders are protected by mortgage of assets and equity share holders are protected by the assets of the company. The investors of mutual funds trust are exposed to high default risk. Hence, there is need for regulatory measures to protect the interests of the investors of the mutual funds. The purpose of the regulatory measures is rightly pointed out by Sadhak (1991). “Regulatory measures, whatever may be their form and structure, are designed to attain the twin objectives of correcting market failures and protecting investors from loss” (Sadhak, 1991). The objectives of the regulations are to ensure management of mutual funds for the benefit of the investors with a fiduciary responsibility, establish confidence amongst investors, protect the physical integrity of the assets, providing adequate and accurate information to the investors, formulate rules and adopt practices for fair valuation of investments, net asset value, purchase & repurchase prices, etc. The regulations should protect the interests of the investors, provide operational freedom to the fund manager and encourage creativity in developing innovative products.

Till 1987, UTI was the only player in the industry enjoying monopoly in the business and the investors developed confidence as it was promoted by the central government. During the period of late eighties, the Indian capital market had undergone a transformation and became more favorable for corporate sector to raise long-term capital by mobilizing household savings and the savings of the small investors. In 1986, UTI launched master share, a close-ended mutual funds scheme and received overwhelming response from the investors. It was in response to these changes, that

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banks and other financial institutions were allowed to diversify in mutual funds business. In July 1987, RBI advised the chief executives of commercial banks to take prior approval of RBI to establish mutual funds. State bank of India and Canara bank launched their schemes by constituting separate trusts. “There were practically no rules because, the government wanted the bank and institution sponsored mutual funds to have some time for the investors to catch up with concept (Jaydev, 1998).” RBI realized the need to issue guidelines as the mutual funds established by banks started assuring returns on the mutual funds schemes and it created a race among the mutual funds. The investors considered mutual funds as alternatives to bank deposits because the mutual funds were sponsored by banks. In July 1989, RBI issued guidelines for mutual funds regarding constitution and management, investment objectives and policies, prudential ceiling limits of investments, pricing policy, income distribution, statement of accounts and disclosures.

The Abid Hussain committee on capital market emphasized the need for strengthening regulatory framework for mutual funds and also recommended the setting up of joint sector mutual funds. In June 1990, government of India issued guidelines on the similar lines with certain additions. The new government guidelines insisted on approval of controller of capital issues and registration with SEBI for the constitution and management of the mutual funds. SEBI directed all the existing mutual funds to make disclosures to the investors and to SEBI and issued a code of advertisement to mention that “mutual funds and security investments are subject to market risks. Past performance is no guarantee for future results”. “SEBI was initially established as an interim body under the ministry of finance to regulate and developed the capital markets which were later converted into a statutory body under the SEBI act, 1992. The mutual funds sponsored by banks were required to fulfill obligations under both sets of regulations.

Dr. S.A. Dave committee submitted its report in September, 1991 and made recommendations for the orderly functioning of mutual funds. SEBI issued guidelines for the formation of Asset Management Companies (AMC) and two tier structures was developed for mutual funds trusts and asset management companies. In February 1992, the government of India announced a comprehensive set of guidelines with an
objective to instill a sense of competition, transparency and fair play and spur the mutual funds to a great level of efficiency and investor friendliness. The purpose of these guidelines was to develop a sense of competition which was necessary in the industry. Transparency was required to ensure fair play and make the mutual funds more investor friendly. After entry of private sector and foreign institutions, SEBI has formulated detailed regulations for mutual funds and these regulations came into force from 20th January, 1993 known as SEBI (mutual funds) regulations, 1993 applicable to all mutual funds except money market mutual funds and foreign mutual funds which were continued to be governed by RBI.

The SEBI regulations were not applicable to UTI as UTI was constituted and governed by the provisions of UTI act, 1963. “A set of common rules are required otherwise two different regulations for the same business activity cripples the efforts to create a level playing field.”

All mutual funds except UTI were regulated by SEBI regulations but UTI continued to be regulated by UTI act, 1963. There were two sets of regulations applicable to mutual funds industry for the same business activity. The Narasimham committee also recommended equal treatment between various mutual funds including UTI. Considering this inequality of treatment a committee was constituted under the chairmanship of Shri N. Vaghual. The committee recommended that UTI should be set up as asset management companies and all existing business of close ended schemes of UTI should be transferred to newly setup asset management company in accordance with the SEBI regulations. As a result of these recommendations, UTI has been brought under the purview of these SEBI without any amendments in the UTI act, 1963. SEBI has been empowered to inspect operation, books and records of UTI.

It was realized that the regulatory system was not functioning up to the mark and need for more regulatory control was realized to protect the interests of the investors. The issues like voting rights to mutual funds, ceiling on corpus amount, capital adequacy, borrowing powers, and insurance coverage to investors, portfolio turnover, nomination and pass book facilities required the existing regulations to be amended. Some of these issues have been incorporated in the new SEBI mutual funds regulations.
regulations, 1996. There are 78 regulations in ten chapters which can be broadly classified under registration, organization and management, disclosure, regulation and control.

3.8.1 Registration of Mutual Funds
i. Application for registration of mutual funds shall be made by the sponsor in form-A (Regulation-3).
ii. A mutual funds shall be constituted in the form of a trust and the trust deed shall be registered under Indian registration act, 1909/8 (Regulation-14)
iii. The application for the approval of asset management company shall be made in form D (Regulation-19)

3.8.2 Organization & Management of Mutual Funds
i. The sponsor shall make an application to SEBI in form A accompanied by non-refundable fees, complete the formalities and furnish information as may be required by SEBI ( Regulations- 3,4,5 & 6)
ii. A mutual funds shall pay the service fees as specified in second schedule before 15th April each year (Regulation-12)
iii. The sponsor or the trustees if so authorized by the trust deed, appoint an asset management company which has been approved by SEBI and any change in the appointment shall be subject to prior approval of SEBI (19 & 20)
iv. The trustees and the asset management company shall enter into an investment management agreement with prior approval of SEBI (18(1))
v. The mutual funds shall appoint a custodian to carry out the custodial services and inform SEBI within 15 days of the appointment and enter into an agreement with the custodian with the prior approval of the trustees. (26 & 27)
vi. All schemes shall be launched by asset management company after approval by the trustees and a copy of the offer document has been filed with SEBI (28)
vii. The asset management company may at its option repurchase or reissue the repurchased units of a close-ended scheme (33).

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allotted to the applicant not later than six weeks from the date of closure of the subscription list (35 & 36)

ix. The asset management company shall, on production of valid instrument of transfer with relevant unit certificates, register the transfer within 30 days of the date of such production unless otherwise restricted or prohibited under the scheme. If the units are with the depository, such units will be transferred in accordance with the provisions of SEBI (Depositories and Participants) Regulations, 1996. (37).

x. The money collected under any scheme of a mutual funds shall be invested only in transferable securities in capital or money market or in privately placed debentures or securitized debts (43)

xi. Each mutual fund shall compute the Net Asset Value (NAV) of each scheme by dividing the net assets of the scheme by the number of units outstanding on the valuation date (48).

xii. The financial year for all the schemes shall end as on 31st March each year and every asset management company shall keep & maintain proper books of accounts, records and documents for each scheme, preserve the records for ten years and follow accounting policies and standards as specified in the ninth schedule (50 & 51).

xiii. Every mutual funds and asset management company shall dispatch the dividend warrants to the unit holders within 30 days of the declaration of dividend and dispatch the redemption or repurchase proceeds within 10 working days from the date of receipt of the request (53).

xiv. Every mutual funds shall have the annual statements of accounts audited by an auditor, not associated with the auditor of asset management company and shall prepare annual report and annual statements of accounts of the schemes and the fund as specified in the eleventh schedule (54 & 55).

xv. A scheme of mutual funds can be wound up before its maturity by passing a resolution with simple majority by the meeting of the unit holders and forward a report to SEBI and the unit holders, explaining circumstances leading to the winding up of the scheme. If SEBI is satisfied that all measures for winding up of the scheme have been complied with, the scheme shall cease to exist. (41 & 42)
3.8.3 Disclosure to Investors and SEBI

i. The offer document of a mutual funds scheme shall contain disclosures which are adequate to enable the investors to make informed investment decisions. SEBI may require the asset management company to carry out modifications in the offer document as it may suggest within 21 days from the date of filing (29).

ii. The advertisements in respect of each scheme shall be in conformity with the advertisement code as specified in the sixth schedule and shall not be misleading or contain any false or incorrect statement (30 & 31).

iii. Every mutual funds shall compute and carry out valuation of its investments in its portfolio and publish the same in accordance with the valuation norms specified in eighth schedule. The NAV of each scheme shall be calculated and published at least in two daily newspapers at intervals of not exceeding one week (47 & 48(2)).

iv. The mutual funds shall make available the price at which units can be subscribed or sold and the price at which the units can be repurchased by the mutual funds and publish once in a week in a daily newspaper of all India circulation (49).

v. The scheme wise annual report of a mutual funds or an abridged summary of such report shall be published through an advertisement as soon as may be but not later than 6 months from the end of the financial year (56).

vi. The mutual funds, the asset management company, the trustee, sponsor and custodian of the mutual funds shall make such disclosures or submit such documents as may be required by SEBI (58).

vii. A mutual funds and asset management company shall publish the unaudited financial results of each half year. I.e. on 31st March & 30th September, within 2 months from the date of each half year, in one English daily newspaper circulating in whole of India and in a newspaper of the region where the head office of the mutual funds is situated (59).

viii. The trustees shall be bound to make such disclosures to the unit holders as are essential in order to keep them informed about any information.

ix. The order of suspension or cancellation of a mutual funds passed under regulation 72(3) may be published by SEBI in two newspapers (74).
3.8.4 Regulation & Control of Mutual Funds

i. The applicant has to fulfill the eligibility criteria for grant of a certificate of registration of mutual funds. The eligibility criteria include sound track record, 40 percent contribution in net worth of asset management company by sponsor, appointment of trustees, asset management company and custodian (7).

ii. The registration granted to mutual funds shall be subject to terms and conditions (10).

iii. The SEBI may not permit mutual funds that has not paid fees to launch any scheme (13).

iv. Disqualification from being appointed, rights and obligations of the trustees (16 & 18).

v. No trustee shall initially or any time thereafter be appointed without prior approval of SEBI (17).

vi. The asset management company has to fulfill the eligibility criteria for seeking approval of SEBI and the approval granted shall be subject to the terms and conditions (21 & 22).

vii. The asset management company shall not act as trustees or undertake any other business activity (24).

viii. Asset management company has to comply obligations of due diligence and care in all its investment decisions (25).

ix. No guaranteed returns shall be provided in a scheme by mutual funds unless such returns are fully guaranteed by the sponsor or asset management company (38).

x. The mutual funds shall not borrow except to meet temporary liquidity needs of the mutual funds and advance any loans for any purpose (44).

xi. The funds of a scheme shall not in any manner be used in option trading or in short selling or carry forward transactions (45).

xii. Mutual funds may enter into underwriting agreement after obtaining a certificate of registration from SEBI authorizing the mutual funds to carry on activities as underwriters (46).

xiii. All expenses of mutual funds schemes shall be clearly identified and appropriated to the individual schemes subject to the limits specified (52).

xiv. Every mutual funds and asset management company shall forward a copy of annual report and other information including details of investments and deposits.
Overview of Mutual Funds

held by the mutual funds so that entire scheme wise portfolio is disclosed to SEBI (57).

xv. SEBI has right to inspect and investigate the affairs of the mutual funds, trustees and asset management company by giving ten days’ notice or without giving notice if SEBI is satisfied that in the interest of the investors no such notice should be given (61 & 62)

xvi. SEBI shall have power to appoint an auditor to inspect or investigate, as the case may be, into the books of accounts or the affairs of the mutual funds, trustee, or asset management company (66).

xvii. The SEBI may suspend a certificate granted to a mutual funds if the mutual funds contravenes the provisions of the act, fails to furnish any information, does not co-operate in any inquiry or inspection, fails to comply the directions of SEBI, fails to resolve the complaints of the investors, indulges in unfair trade practices, fails to pay any fees or guilty or guilty of misconduct, etc. (68).

3.8.5 New Proposed Regulations for the Development of Mutual Funds Industry

The equity investment in a company by mutual funds should be limited to 10 per cent of the net asset value (NAV). The committee appointed by SEBI to advise the regulatory body on matters relating to the development and regulation of mutual funds in the country, recently made its recommendations. However, the exception to the limit is that this is not applicable in case of the scheme with an objective of investment in index funds and in case of sector or industry specific schemes. In such cases, the limit shall be 10 percent or the weightage of the scripts in the index or sub index of the sector whichever is higher subject to adequate disclosures in the offer documents.

As per the earlier regulation, no mutual funds under all its schemes could own more than 10 percent of any company's paid-up capital carrying voting rights. The committee has also made its recommendations for investment in debt securities. As per existing regulations, there are no restrictions on the investments in debt securities of a single issuer. The committee recommended that the investment on debt instrument issued by a single issuer be restricted to 15 percent of NAV of the scheme

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and this limit may be extended to 25 percent of the NAV of the scheme with the prior approval of the board of the asset management company (AMC) and board of trustees. Again exceptions to the proposed rule are government securities and money market instruments. The committee also recommended restricting the investment in unlisted shares to a maximum of 10 percent of the NAV of the scheme in case of close ended scheme and open-ended schemes. The list may be made more stringent to 5 percent of the NAV of the scheme as there are continuous purchases by investors in such a scheme.

As far as debt instruments without rating concern, the committee recommended that the investment in such a scheme should not exceed 15 percent of NAV of a scheme and this limit may be extended to 25 percent provided the AMC gets the prior approval of the board of the AMC and board of trustees. Presently mutual funds can invest up to 25 percent of the NAV of all of its schemes in the listed securities of group companies of the sponsor. This provision is liable to be misused since it is possible that the mutual funds can invest the entire NAV of any one of the scheme in the group companies and still be within the 25 percent limit of all its schemes. Therefore, the committee recommended that such hit of 25 percent should be for NAV of each scheme separately and not for all the schemes of a mutual funds put together.

Under the existing regulations in case of change in control and change in fundamental attributes, $3/4^{th}$ of the unit holders’ approval is required. Mutual funds have represented that this clause may be relaxed in the case of open ended schemes as the unit holders have an exit option throughout the life of the scheme. If the investors do not agree to the changes proposed by the mutual funds they can exit at any time at the prevailing NAV.

A pre-condition for such change may be that the unit holders should be informed by way of individual communication and through advertisements in the newspapers. The committee considered the proposal and found acceptable. The committee further recommended that the mutual funds should disclose at the time of declaring half-yearly and yearly results any underwriting obligations undertaken by the schemes of...
the mutual funds with respect to issue of associate companies, development, if any, subscription by the schemes in the issues lead managed by associate companies and subscription to any issue of equity or debt on private placement basis where the sponsor or its associate companies have acted as manager.

The Association of Mutual funds in India (AMFI) has submitted a series of recommendations to Security and Exchange Board of India (SEBI) for upgrading the standards of Indian mutual funds industry to the international levels while entering the new millennium.

AMFI has approved various initiatives like semi-annual disclosure of portfolio, recommendations regarding non-performing assets (NPA), formation of audit committee of trustees, setting up valuation committee by asset management companies (AMCs), investor education, setting up of committees on best practices to formulate proposal for individual retirement plan and review impact of credit policy measures.

In case of disclosure, the AMFI has suggested SEBI norms for mandatory semi-annual disclosure to mutual funds. Currently the mutual funds regulation provides for disclosure of full portfolio in the balance sheet and the annual report sent to the unit holders once a year. Now in order to enhance the level of disclosure standards and to bring it on par with international levels, AMFI has suggested that the mutual funds should made disclosure of portfolio twice in a year. In order to promote fairness in the treatment of non-performing assets relating to debt securities by all mutual funds, the five member AMFI committee headed by Nijamatullah also made recommendations like identification of assets as NPA, provisioning of income, provisioning of asset value and disclosures by mutual funds. Besides these, the AMFI board has suggested formation of audit committee by the board of trustees, formation of valuation committee by the AMC, trading securities by employees of AMC, investor education and training of agents and intermediaries.

During 1995-96, SEBI had prepared and widely circulated a paper titled "Mutual funds 2000" which identified ways to improve the working and regulation of the
mutual funds industry, so that mutual funds could provide a better performance and service to all categories of investors and offer a range of innovative products in a competitive manner to match investor needs and preferences across various investor segments. Based on the comments received on the recommendations made in the paper by market participants and investors and on discussions held with the Association of Mutual funds of India (AMFI), the SEBI (Mutual funds) Regulations, 1993 were revised and the new regulations notified in December 1996 known as the SEBI (Mutual funds) Regulations, 1996.

The revised regulations embodied far reaching changes in the regulation and functioning of mutual funds. The revised regulations provide for

- Enhanced level of investor protection
- Empowerment of investors
- Stringent disclosure norms in the offer documents, so that investors are better informed, better advised, better awareness of risks and rewards
- Standardization of norms for valuation of assets, computation of Net Asset Values (NAVs) of schemes of mutual funds and accounting standards and policies.
- Complete freedom to AMCs to structure schemes in accordance with investor preferences
- Removal of quantitative restrictions on investment by mutual funds and replacement by prudential supervision.
- Guaranteed return schemes by mutual funds provided returns including capital were guaranteed.
- Indication of expected returns based on hypothetical portfolio permitted.
- Better governance of mutual funds through higher responsibilities and empowerment of trustees as front-line regulators of mutual funds
- Closer scrutiny through off site and onsite inspections.
- Code of ethics for asset management companies

The impact of the new regulations was immediately felt. Asset management companies framed several schemes which made use of the freedom provided to them by the new regulations. Not only did the number of schemes filed with SEBI increase "A study of Awareness, Opportunities & Problems for Retail Investors with Reference to Mutual Funds In Gujarat State"
significantly in a short period of time, but also there was greater variety in the investment products offered. There was also a significant improvement in disclosures in the offer documents.

The new regulations have brought into greater focus the responsibilities of trustees of mutual funds who are uniquely positioned to promote the interests of the unit holders and to ensure that mutual funds are managed responsibly and ethically. The trustees act independently to uphold the public trust in this process, trustees act as the first level regulation and are critical in helping to ensure the profitability and progress of the mutual funds. To assist trustees in their new role, and to set out the manner in which they could best perform this role, SEBl appointed a committee under the chairmanship of Shri. P. K. Kaul, former Cabinet Secretary and Ambassador to the United States.

SEBI is using its interface with AMFI to assess the impact of the new regulations on the working of mutual funds and to examine further ways of improving the performance of mutual funds so as to restore investor confidence in them. SEBI also continued working with AMFI so that it becomes a more effective body representing the mutual funds industry and embarks on a campaign to sharpen the industry's focus on the consumer.

3.9 Organization and Management Pattern of SEBI Regulated Mutual Funds

The organization and management of non UTI mutual funds need to be studied for pre SEBI and post SEBI periods. The mutual funds set-up by nationalized banks and insurance companies’ involve three parties as under.

i. Senior of the trust or the sponsoring organization.
ii. The trust formed under the Indian trusts act, 1882 or the trustee company registered under the companies act, 1956.
iii. Fund manager or asset management company

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All these parties had different and distinct role in the management of the mutual funds business. An “Arm’s Length” distance was required to be maintained between the setter, trustees of the trust or directors of the trustee company, and the fund managers. “In India as per the practice in vogue in structuring mutual funds no “Arm’s Length” distance used to be observed between the sponsor of the trust, the trustees and the fund managers, as very often, the persons manning the above three distinct positions emerge from one single employer or sponsoring organization. For example, in case of Canbank mutual funds, the trust has been settled by Canara bank as sponsor and again the members of Canara bank’s board or executive class are the trustees, and the subsidiary, promoted by the Canara bank known as Canbank financial services limited served as fund managers.” All the mutual funds followed the same pattern of management and organization as followed by UTI i.e. they had under one roof the sponsor, the trust, fund manager and custodian.

**Table – 3.2 - Organization of Pre-SEBI Period Mutual Funds**

<table>
<thead>
<tr>
<th>Sr.</th>
<th>Name of Mutual funds</th>
<th>Sponsor</th>
<th>Trustees</th>
<th>Fund Manager</th>
<th>Custodian</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>SBI</td>
<td>SBI</td>
<td>SBI Capital Markets. Ltd.</td>
<td>SBI</td>
<td>SBI</td>
</tr>
<tr>
<td>2</td>
<td>Canbank</td>
<td>Canara Bank</td>
<td>Canara Bank</td>
<td>Canbank fin. Service. Ltd</td>
<td>Canbank</td>
</tr>
<tr>
<td>3</td>
<td>LIC</td>
<td>LIC</td>
<td>SHCI</td>
<td>LIC</td>
<td>SHCI</td>
</tr>
<tr>
<td>4</td>
<td>Ind. Bank</td>
<td>Indian Bank</td>
<td>Indian Bank</td>
<td>Ind. Bank</td>
<td>Indian Bank</td>
</tr>
<tr>
<td>5</td>
<td>BOI</td>
<td>Bank of India</td>
<td>BOI</td>
<td>BOI Finance Ltd.</td>
<td>BOI Fin. Ltd.</td>
</tr>
<tr>
<td>7</td>
<td>GIC</td>
<td>GIC</td>
<td>Own board of trustee</td>
<td>GIC</td>
<td>SHCI</td>
</tr>
<tr>
<td>8</td>
<td>UTI</td>
<td>UTI</td>
<td>-do-</td>
<td>UTI</td>
<td>SHCI/City bank.</td>
</tr>
</tbody>
</table>

*Source: Verma J.C: Mutual funds & Investment Portfolio, PP-82.*

From the above table it can be said that the sponsors, trustees, fund managers and the custodians were the same persons with no difference between the organization and management of the mutual funds and its constituents. “The above organization set-up..."
could be presented algebraically in following summation. \[ MF = f(ABCD) \] Where mutual funds = collective function of A (Sponsor), B (Trustee), C (Fund Manager), D (Custodian).

In all the banks’ sponsored mutual funds the organizational set up existed in the above form where all the important operations in the management of mutual funds were done under one roof cover.”

A study group was set up following the announcement by the Union Finance Minister, Dr. Manmohan Singh, in his budget speech that the private sector would be allowed to float mutual funds. The ten member study group headed by Dr. S.A. Dave, the then chairman of UTI, was asked by the central government in 1991 to evolve a framework of legislation for organization and management of mutual funds that may be permitted in the private sector. The central government issued guidelines dated 14th February, 1992 based on the recommendations of Dr. S. A. Dave committee. The pre-SEBI period set up explained by \[ MF = f(ABCD) \] has been changed to \[ MF = f(A) + f(B) + f(C) + f(D) \] wherein each constituent is a separate legal entity with “arm’s length” relationship and no linkages leaving scope for mismanagement. The central government guidelines have been replaced by SEBI (mutual funds) Regulations, 1993 and these regulations subsequently replaced by SEBI (mutual funds) Regulations, 1996.

In accordance with the SEBI (mutual funds) Regulations, 1996, the constituents of mutual funds are as under.

1. Sponsor
2. Mutual Funds Trustee
3. Asset Management Company or Fund Manager.
4. Custodian.
3.9.1 Sponsor

Under regulation 2(x) of the SEBI Regulations, 1996 “Sponsor” means person who, acting alone or in combination with another body corporate, establishes a mutual funds. The sponsor should have a sound track record and general reputation of fairness and integrity in all its business transactions. The sound track record means, the sponsor should have minimum five years’ experience in the relevant field of financial services, net worth is positive for the last five years, net worth of the last year is more than capital contribution in the asset management company and earned profit after providing depreciation, interest and tax in three out of immediately preceding five years including the fifth year. The sponsor is required to contribute 40 percent to the net worth of the asset management company. If any person holds more than 40 percent of the net worth of an asset management company, such person shall be deemed to be a sponsor and required to fulfill the eligibility criteria specified in these regulations.

The sponsor or any of its directors or the principal officer to be employed by the mutual funds should not have been guilty for fraud or convicted or an offence involving moral turpitude or found guilty of an economic offence. It will prevent economic offenders in promotion and management of mutual funds. The sponsor is required to appoint the following.

i. Trustees, act as trustees for the mutual funds.

ii. Asset management company to manage the funds.

iii. Custodian to keep the securities in its custody.

The sponsor is required to make application in form A with non-refundable application fees of Rs. 25000. The SEBI on receipt of all information may decide the application. On approval from SEBI and payment of registration fees of Rs. 25 lakh by the applicant, SEBI may register the mutual funds and grant the certificate in form B subject to the terms and conditions.
3.9.2 Trustees

Under Regulation 2(y) of the SEBI regulations, 1996, “trustee” means a person who holds the property of the mutual funds in trust for the benefit of the unit holders and includes a trustee company and the directors of the trustee company. A mutual funds is managed by the board of trustee who hold the property of the mutual funds in trust for the benefit of the unit holders who invest their savings in the corpus of the fund. A person can’t be a trustee or a director of a trustee company in more than one mutual funds and one half of the trustee should be independent of the sponsors. The asset management company, its directors or employees, shall not act as trustee of any mutual funds. A trustee of mutual funds can’t be appointed as a trustee of any other mutual funds without the prior permission from the mutual funds in which he is already an independent trustee. No trustee is appointed without prior approval of SEBI.

Mutual funds shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed executed by the sponsor in favor of the trustees or a trustee company and duly registered under the provisions of the India registration act, 1908. The trust deed shall contain the contents and clauses as mentioned in the third schedule of the SEBI regulations 1996. However, no clause shall limit or extinguish the obligations and liabilities of the trust and indemnify the trustees or the asset management company.

The trustees or trustee company shall appoint an asset management company and enter into an investment management agreement with asset management company, ensure and observe that asset management company manages schemes in accordance with the trust deed and the investment management agreement, provide information to the unit holders and comply the requirements. The trustees or trustee company are paid the trusteeship fees as specified in the trust deed and act in the best interest of the unit holders. The trustees are made more responsible in managing the business of the mutual funds and as such the rights and obligations of the trustees have been specified under regulation 18 of the SEBI regulations, 1996. At least 50 percent of the trustees shall be independent persons and no such trustee shall be associated in any manner with the sponsor. The independence of the independent trustees can’t be maintained.
as the trustees or directors of the trustee companies are appointed by the sponsors. “Many private sector sponsors have preferred the trustee company structure, over the board of trustee because in their view, the liability of the trustees is more difficult under the board of trustees’ structure compared to the trustee company structure. There appears to be difference with regard to liabilities of the trustee under both the structures (Mutual funds year book – 2000).”

3.9.3 Asset Management Company (AMC)

An asset management company is appointed by the trustees to float and manage the schemes of the mutual funds. An asset management company is also known as investment manager as it manages the funds raised by selling the units. Under regulation 2(d) of the SEBI regulations, 1996, “asset management company” means a company formed and registered under the companies act, 1956 and approved by SEBI under regulation 21(2). The asset management company must act as per SEBI guidelines and the trust deed and the investment management agreement entered between the trustees or trustee company and the asset management company. The memorandum and articles of association of asset management company must be approved by SEBI. It operates all the schemes of the mutual funds having expertise in portfolio management, investment management and financial administration. It can act as asset management company of only one mutual fund and can’t act as a trustee of any other mutual funds. It should have sound track record of net worth, dividend payment and profitability.

Most of the asset management companies are promoted by the sponsors as the sponsors contributes 40 percent to the net worth of the asset management company. Its directors should be expert in the business activities of mutual funds and at least one half of the directors should be independent persons. The asset management company shall not undertake any other business activity other than management of the mutual funds and such other financial services activities not in conflict with fund management activities.

The names of the directors and any subsequent changes must be intimated to SEBI. A director of an asset management company shall not act as director of any other asset

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management company, trustee or director in a trustee company of a mutual funds operated by the same asset management company. No person should be a trustee director of more than one board of trustees/trustee company. Any change in the appointment of the AMC shall be subject to prior approval of SEBI and the unit holders. No appointment of a director of an AMC shall be made without prior approval of the trustees and any change in controlling interest of the AMC shall be made only with prior approval of trustees, SEBI and the unit holders. The appointment of an AMC can be terminated by majority of the trustees or by 75 percent of the unit holders of the scheme.

The SEBI regulations, 1996 have prescribed eligibility criteria for appointment of an AMC under regulation 21, terms and conditions to be complied with by AMC under regulation 22, its obligations under regulation 25 and regulation 24 states restrictions on business activities of the AMC. The directors of AMC cannot oppose the management of AMC to protect the interests of the unit holders as they are appointed by the management.

3.9.4 Custodian

Under regulation 2(h) of SEBI regulations, 1996, “custodian” means a person who has been granted a certificate of registration to carry on the business of custodian of securities under the SEBI regulation, 1996. The role of custodian is to keep the securities in safe custody and ensure ready availability of such security. The mutual funds shall appoint a custodian and enter into a custodian agreement with the custodian with the prior approval of the trustees and send intimation to SEBI within 15 days of appointment. No custodian in which the sponsor or its associates hold 50 percent or more of the voting rights of the share capital of the custodian or where 50 percent or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual funds constituted by the same sponsor or any of its associates or subsidiary company. The job of custodians has become easier with dematerialization of large number of securities. “Automation eliminates manual handling and reduces requisition and delivery time and brings efficiency in operations of a custodian (SEBI, 2011).”

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As per mutual funds year book 2000, twenty five mutual funds have appointed a single custodian, eight mutual funds have appointed two custodians, GIC mutual funds has appointed three custodians and SBI mutual funds has appointed four custodians including SBI, sponsor of SBI mutual funds. HDFC bank limited is custodian for nine mutual funds including HDFC mutual funds. Stock holding corporation of India is custodian for eight mutual funds followed by Citibank and Duestche bank custodians for six mutual funds. Southern India depository services private limited is custodian for Kothari Pioneer mutual funds only. All other custodians have more than two mutual funds as their clients. The foreign banks are custodians for nineteen mutual funds. The foreign banks custodians are Citibank, Duestche bank, Standard Chartered bank and ABN Amro bank.

The SEBI mutual funds regulation have defined the structure of mutual funds and segregated the various constituents into separate legal entities. The mutual funds are set up as trusts governed by board of trustees or trustee companies. They are to be managed by separate AMC. The custody of the assets is to be with a custodian who is independent of the sponsors and the AMCs. Arm’s length relationships have been sought to be built into the various constituents of a mutual funds, primarily through separation of the entities, and through the requirement that 50 percent of the trustees and also 50 percent of the board of directors of the AMC must be independent and not associated or affiliated to the sponsor.

3.10 Growth of Mutual Funds in India
The idea of pooling money dates back to 1822, when groups of people in Belgium established a company to finance investments in national industries under the name of ‘Societe Generale de Belgique’, incorporating the concept of risk sharing (Rouwenhorst, 1995). The institution acquired securities from a wide range of companies and practiced the concept of mutual funds for risk diversification. In India, however, the need for the establishment of mutual funds was felt in 1931, and in 1954, the committee on finance for the private sector recommended mobilization of savings of the middle-class investors through unit trusts in India. Thus, in 1963, the concept of mutual funds took root in India when UTI was set up with the twin
objectives of mobilizing household savings and investing the funds in the capital market for industrial growth.

The UTI was the first mutual funds set up under the act of the parliament. It became operational in July 1964 by the farsighted vision of Sri T.T. Krishnamachari, the Finance Minister. The first scheme launched by UTI was Unit Scheme 1964 (US-64), the first open ended and the most popular scheme. And, by the end of 1988, UTI had 67000 million of assets under management.

Over a period of 25 years, UTI funds grew fairly successfully and gave investors a good return and therefore, in 1989, as the next logical step, public sector banks and financial institutions were allowed to float mutual funds; and their success emboldened the government to allow private sector to foray into this area (Sarkar, 1991).

Since then, Indian mutual funds industry had seen dramatic improvements, both quality wise as well as quantity wise. The late 1980s and early 1990s marked the entry of public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). State bank of India (SBI) mutual funds was set up in June 1987, followed by Canara Bank mutual funds in December 1987, Punjab national bank mutual funds in August 1989, Indian bank mutual funds in November 1989, Bank of India mutual funds in June 1990 and Bank of Baroda mutual funds in October 1992. The LIC established its mutual funds in June 1989, while GIC had set up its mutual funds in December 1990.

A new era was started in the Indian mutual funds industry with the introduction of private sector mutual funds in 1993. In January 1993, the first mutual funds regulations by Securities and Exchange Board of India (SEBI) came into being, under which all mutual funds, except UTI, were required to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual funds registered in July 1993. Thereafter, number of mutual funds houses went on increasing, with many foreign mutual funds setting up funds in India, and also the industry has witnessed several mergers and acquisitions. This significant

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growth has been aided by a more positive sentiment in the capital market, significant tax benefits and improvement in the quality of investor service (Mehru, 2004).

The Indian mutual funds industry is one of the fastest growing segments of the Indian economy. During the last 10 year period, the industry has grown at nearly 22 percent compound annual growth rate (CAGR). With assets of US$ 125 billion, India ranks nineteenth and is one of the fastest growing, among the countries of the world. The factors contributing to the growth of the industry are: large market potential—high savings rate; comprehensive regulatory framework; favorable tax policies; introduction of new products; role of distributors; investor education campaign; and past performance record (Dave, 1992).

The Indian mutual funds industry currently consists of 44 players that have been given regulatory approval by SEBI. From the plain vanilla equity and debt products, the industry now has an array of different products such as thematic funds, exchange traded funds, gold funds, capital protection oriented funds, funds based on analytical models and even funds investing in overseas markets. Due credit for this evolution goes to the regulators for creating appropriate enabling regulations for these products and the fund houses for effectively launching such products in the Indian markets (Ramola, 1992).

All this has prompted the mutual funds investors to come out of their comfort zone of fixed deposits and government savings schemes with assured returns in search of green pastures in terms of additional returns. The trend is encouraging and is drawing more and more participants to the investment management industry. Participants can visibly see the underlying potential in the Indian markets and are keen to participate.

The ratio of assets under management (AUM) to India’s GDP gradually increased from 6 percent in 2005 to 11 percent in 2009. But it continues to be significantly lower than the ratio in developed countries where the AUM accounts for 20 to 70 percent of the GDP. However, India’s low penetration level (AUM to GDP ratio) indicates significant scope for future growth.
The growing popularity of mutual funds proves that it is an ideal investment vehicle for small investors having limited information and knowledge to enter today’s complex and modern capital market (VidyaShankar, 1990). The domestic mutual funds industry has grown by 50 percent, particularly through systematic investment plan (SIP) from retail participants. But, there is still a long way to go as only 5 percent of the households are investing in mutual funds schemes.

The tremendous growth of Indian mutual funds industry is an indicator of the efficient financial market; we are currently having (Tripathy, 1996). Now, the industry is playing very significant role in channelizing the savings of millions of individuals into investment in equity and debt instruments. Thus, resource mobilization by mutual funds is an important activity in the Indian financial market. Table 3.3 shows the mobilization of funds by the Indian mutual funds industry for the period 1987–88 to 2009–10.
Resource mobilization is very significant for the economic growth of a developing country like India. Resource mobilization from surplus-spending units and efficient channelization of the same to the deficit-spending units can contribute to the real economic growth of a nation. In this context, the role of mutual funds industry cannot be overemphasized. Unit trust of India was the only mutual funds until 1987–88 grew at a steady rate until 1993–94; since then, it showed some variations between 1994–95 and 1999–2000. Resources mobilized by mutual funds, which was just 0.04 percent of gross domestic product (GDP) at constant prices (GDP) in 1970–71, increased to 1.91 percent in 1992–93 and to 7.83 percent in 1993–94.

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Total resources mobilized as proportion of GDP declined to 1.48 percent in 1994–95; and remained as low as 0.37 percent in 1996–97, but nevertheless remained positive. The gross funds mobilized as a proportion of real GDP again showed a continuous increased from 3.43 percent in 1999–2000 to a sizeable level of 110 percent in 2008–09. Thus, Indian mutual funds industry seems to play a vital role in the process of mobilization of economic resources for inclusive growth of the country (Rao and Mishra, 2007).

Table 3.4 shows the growth in net assets of Indian mutual funds industry on year basis.

Table 3.4 - Net Assets of Indian Mutual Funds Industry

(Rs. in crores.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Year on Year Growth Rate (percent)</th>
<th>Net Accretion to Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>24.67</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>1966</td>
<td>25.94</td>
<td>5.15</td>
<td>1.27</td>
</tr>
<tr>
<td>1967</td>
<td>33.86</td>
<td>30.53</td>
<td>7.92</td>
</tr>
<tr>
<td>1968</td>
<td>48.70</td>
<td>43.83</td>
<td>14.84</td>
</tr>
<tr>
<td>1969</td>
<td>65.40</td>
<td>34.29</td>
<td>16.70</td>
</tr>
<tr>
<td>1970</td>
<td>88.30</td>
<td>35.02</td>
<td>22.90</td>
</tr>
<tr>
<td>1971</td>
<td>105.14</td>
<td>19.07</td>
<td>16.84</td>
</tr>
<tr>
<td>1973</td>
<td>141.96</td>
<td>19.03</td>
<td>22.70</td>
</tr>
<tr>
<td>1974</td>
<td>172.09</td>
<td>21.22</td>
<td>30.13</td>
</tr>
<tr>
<td>1975</td>
<td>169.95</td>
<td>-1.24</td>
<td>2.14</td>
</tr>
<tr>
<td>1976</td>
<td>176.66</td>
<td>3.95</td>
<td>6.71</td>
</tr>
<tr>
<td>1977</td>
<td>206.84</td>
<td>17.08</td>
<td>30.18</td>
</tr>
<tr>
<td>1978</td>
<td>279.91</td>
<td>35.33</td>
<td>73.07</td>
</tr>
<tr>
<td>1979</td>
<td>393.70</td>
<td>40.65</td>
<td>113.79</td>
</tr>
<tr>
<td>1980</td>
<td>455.30</td>
<td>15.65</td>
<td>61.60</td>
</tr>
<tr>
<td>1981</td>
<td>513.97</td>
<td>12.89</td>
<td>58.67</td>
</tr>
<tr>
<td>1982</td>
<td>679.24</td>
<td>32.16</td>
<td>165.27</td>
</tr>
<tr>
<td>1983</td>
<td>870.24</td>
<td>28.12</td>
<td>191.00</td>
</tr>
<tr>
<td>1984</td>
<td>1261.33</td>
<td>44.94</td>
<td>391.09</td>
</tr>
<tr>
<td>1985</td>
<td>2209.61</td>
<td>75.18</td>
<td>948.28</td>
</tr>
<tr>
<td>1986</td>
<td>3218.34</td>
<td>45.65</td>
<td>1008.73</td>
</tr>
<tr>
<td>1987</td>
<td>4563.68</td>
<td>41.80</td>
<td>1345.34</td>
</tr>
<tr>
<td>1988</td>
<td>6870.81</td>
<td>50.55</td>
<td>2307.13</td>
</tr>
<tr>
<td>1989</td>
<td>13455.65</td>
<td>95.84</td>
<td>6584.84</td>
</tr>
<tr>
<td>1990</td>
<td>19130.92</td>
<td>42.18</td>
<td>5675.27</td>
</tr>
<tr>
<td>1991</td>
<td>23161.47</td>
<td>21.07</td>
<td>4030.55</td>
</tr>
<tr>
<td>1992</td>
<td>37973.47</td>
<td>63.95</td>
<td>14812.00</td>
</tr>
<tr>
<td>1993</td>
<td>47733.50</td>
<td>25.70</td>
<td>9760.03</td>
</tr>
</tbody>
</table>

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The mutual funds industry is a fast growing sector of the Indian capital and financial markets. “The net assets of the mutual funds industry stood at 8.67 percent of the equity market capitalization and 21 percent of debt market capitalization at the end of 2000. The net assets of mutual funds are 11.18 percent of bank deposits (Mutual fund year book – 2000).” The main segments in the mutual funds industry are UTI, bank sponsored mutual funds, financial institutions sponsored mutual funds, and joint-venture private sector funds predominantly – foreign and Indian and Indian private sector mutual funds.

The composition of the mutual funds industry has changed during the period 2000 to 2007. According to association of mutual funds in India (AMFI) there were 326 schemes in 2000 which was increase to 670 schemes as on 30th June 2007. As on 30th June 2011, there were 44 assets management companies with asset under management (AUM) Rs. 613979 crores. UTI launched 203 new schemes where as other mutual funds launched more than 400 new schemes during the same period. There was a significant increase in schemes of joint venture & Indian private sector mutual funds from 24 schemes in 1996 to almost 400 schemes at the end of year 2010. Net assets of UTI had shown a growth rate of 2.18 percent whereas mutual funds sponsored by banks and financial institutions had witnessed negative growth rates of 0.80 percent and 7 percent respectively. The foreign joint venture private sector mutual funds

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Assets</th>
<th>Return</th>
<th>AUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>62430.05</td>
<td>30.79</td>
<td>14696.55</td>
</tr>
<tr>
<td>1995</td>
<td>72967.17</td>
<td>16.88</td>
<td>10537.12</td>
</tr>
<tr>
<td>1996</td>
<td>74315.31</td>
<td>1.85</td>
<td>1348.14</td>
</tr>
<tr>
<td>1997</td>
<td>70197.41</td>
<td>-5.54</td>
<td>-4117.90</td>
</tr>
<tr>
<td>1998</td>
<td>97228.00</td>
<td>38.51</td>
<td>27030.50</td>
</tr>
<tr>
<td>1999</td>
<td>68193.00</td>
<td>-29.86</td>
<td>-29035.00</td>
</tr>
<tr>
<td>2000</td>
<td>107946.00</td>
<td>58.29</td>
<td>39753.00</td>
</tr>
<tr>
<td>2001</td>
<td>90586.87</td>
<td>-16.08</td>
<td>-17359.13</td>
</tr>
<tr>
<td>2002</td>
<td>100594.2</td>
<td>11.05</td>
<td>10007.33</td>
</tr>
<tr>
<td>2003</td>
<td>109299.4</td>
<td>8.65</td>
<td>8705.20</td>
</tr>
<tr>
<td>2004</td>
<td>139616.3</td>
<td>27.74</td>
<td>30316.90</td>
</tr>
<tr>
<td>2005</td>
<td>149600.4</td>
<td>7.15</td>
<td>9984.10</td>
</tr>
<tr>
<td>2006</td>
<td>231862.47</td>
<td>54.99</td>
<td>82262.07</td>
</tr>
<tr>
<td>2007</td>
<td>326292.00</td>
<td>40.73</td>
<td>94429.53</td>
</tr>
<tr>
<td>2008</td>
<td>505152.00</td>
<td>54.82</td>
<td>178860.00</td>
</tr>
<tr>
<td>2009</td>
<td>417300.00</td>
<td>-17.39</td>
<td>-87852.00</td>
</tr>
<tr>
<td>2010</td>
<td>613979.00</td>
<td>47.13</td>
<td>196679.00</td>
</tr>
<tr>
<td>2011</td>
<td>592250.00</td>
<td>-3.54</td>
<td>-21729.00</td>
</tr>
</tbody>
</table>

Source: SEBI bulletins and SEBI Website and

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recorded the highest growth rate of 77.92 percent in net assets followed by 59.55 percent by Indian joint venture private sector mutual funds and 42 percent by Indian private sector mutual funds.

3.11 Chronological Account of Mutual Funds
The first mutual funds in India have been started by UTI in 1963. UTI has established a statutory body and started its operations from 1st February, 1964. Banks, insurance companies and other financial institutions were allowed to diversity in mutual funds in 1987. The government allowed private sector and foreign financial institutions to set up mutual funds in 1992. The following mutual funds have been working as on June, 2011.

Table – 3.5 - Names of Sponsors & Year of Starting of Mutual Funds

<table>
<thead>
<tr>
<th>No.</th>
<th>Year of Starting</th>
<th>Name of Sponsor</th>
<th>Name of Mutual funds</th>
<th>Name of AMC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1964</td>
<td>Central Government</td>
<td>UTI Mutual funds</td>
<td>UTI</td>
</tr>
<tr>
<td>2</td>
<td>1987</td>
<td>Canara bank</td>
<td>CAN BANK Mutual funds</td>
<td>Canara Robeco</td>
</tr>
<tr>
<td>3</td>
<td>1987</td>
<td>Sahara India Financial Corporation Limited (SIFCL)</td>
<td>SAHARA Mutual funds</td>
<td>SAHARA</td>
</tr>
<tr>
<td>4</td>
<td>1987</td>
<td>State bank of India</td>
<td>SBI Mutual funds</td>
<td>SBI Funds</td>
</tr>
<tr>
<td>5</td>
<td>1989</td>
<td>LIC</td>
<td>LIC NOMURA Mutual funds</td>
<td>LIC NOMURA</td>
</tr>
<tr>
<td>6</td>
<td>1992</td>
<td>Bank of Baroda</td>
<td>BOB Mutual funds</td>
<td>Baroda Pioneer</td>
</tr>
<tr>
<td>7</td>
<td>1993</td>
<td>HB portfolio &amp; Lazard India Limited</td>
<td>Taurus Mutual funds</td>
<td>Taurus</td>
</tr>
<tr>
<td>8</td>
<td>1993</td>
<td>ICICI Prudential</td>
<td>ICICI Prudential Mutual funds</td>
<td>ICICI Prudential</td>
</tr>
<tr>
<td>9</td>
<td>1993</td>
<td>Morgan Stanley</td>
<td>Morgan Stanley Mutual funds</td>
<td>Morgan Stanley</td>
</tr>
<tr>
<td>10</td>
<td>1994</td>
<td>Birla Global finance Limited</td>
<td>Birla Mutual funds</td>
<td>Birla Sun Life</td>
</tr>
<tr>
<td>11</td>
<td>1994</td>
<td>IDBI &amp; Principal finance Services Limited</td>
<td>IDBI Mutual funds</td>
<td>IDBI</td>
</tr>
<tr>
<td>12</td>
<td>1994</td>
<td>JM Financial &amp; investment Services Limited</td>
<td>JM Mutual funds</td>
<td>JM Financial</td>
</tr>
<tr>
<td>13</td>
<td>1994</td>
<td>Principal Financial Group, Punjab National Bank and Vijaya Bank</td>
<td>Principal Mutual funds</td>
<td>Principal PNB</td>
</tr>
<tr>
<td>14</td>
<td>1995</td>
<td>Reliance Capital Limited</td>
<td>Reliance Mutual funds</td>
<td>Reliance Capital</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>1995</td>
<td>Tata Sons Limited &amp; Tata Investment Limited</td>
<td>TATA Mutual funds</td>
<td>TATA</td>
</tr>
<tr>
<td>16</td>
<td>1996</td>
<td>AIG Capital Corporation (AIGCC)</td>
<td>AIG Mutual funds</td>
<td>AIG Global</td>
</tr>
<tr>
<td>17</td>
<td>1996</td>
<td>DSP Merrill Lynch &amp; Merrill Lynch Investment Managers U.K.</td>
<td>DSP Black Rock Mutual funds</td>
<td>DSP Black Rock</td>
</tr>
<tr>
<td>18</td>
<td>1996</td>
<td>Edelweiss Financial Services Limited</td>
<td>Edelweiss Mutual funds</td>
<td>Edelweiss</td>
</tr>
<tr>
<td>19</td>
<td>1996</td>
<td>Escorts financial services Limited</td>
<td>Escorts Mutual funds</td>
<td>Escorts</td>
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<td>20</td>
<td>1996</td>
<td>Franklin Resources Limited</td>
<td>Templeton India Mutual funds</td>
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<td>21</td>
<td>1996</td>
<td>L&amp;T Finance Limited (LTF)</td>
<td>L&amp;T Mutual funds</td>
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<td>22</td>
<td>1996</td>
<td>Sundaram Finance Limited</td>
<td>Sundaram Netwo Mutual funds</td>
<td>Sundaram</td>
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<td>23</td>
<td>1997</td>
<td>ING group</td>
<td>ING savings Mutual funds</td>
<td>ING</td>
</tr>
<tr>
<td>24</td>
<td>1998</td>
<td>Kotak Mahindra Finance Limited</td>
<td>Kotak Mahindra Mutual funds</td>
<td>Kotak Mahindra</td>
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<td>25</td>
<td>2000</td>
<td>HDFC</td>
<td>HDFC Mutual funds</td>
<td>HDFC</td>
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<td>26</td>
<td>2001</td>
<td>HSBC securities and capital markets(India private Limited)</td>
<td>HSBC Mutual funds</td>
<td>HSBC</td>
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<tr>
<td>27</td>
<td>2001</td>
<td>Deutsche Bank A.G</td>
<td>DEUTSCHE Bank Mutual funds</td>
<td>Deutsche (India)</td>
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<tr>
<td>28</td>
<td>2004</td>
<td>BNP Paribas Investment Partners Asia Limited</td>
<td>BNP Paribas Mutual funds</td>
<td>BNP Paribas</td>
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<td>29</td>
<td>2006</td>
<td>JPMorgan Asset Management (Asia) Inc.</td>
<td>JP MORGAN Mutual funds</td>
<td>JPMorgan</td>
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<td>30</td>
<td>2006</td>
<td>Mirae Asset Global Investments Company Limited, Korea</td>
<td>Mirae Asset Mutual funds</td>
<td>Mirae Asset</td>
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<td>31</td>
<td>2006</td>
<td>Quantum Advisors Private Limited</td>
<td>QUANTUM Mutual funds</td>
<td>QUANTAM</td>
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<td>32</td>
<td>2006</td>
<td>Religare Enterprises Limited</td>
<td>Religare Mutual funds</td>
<td>Religare</td>
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<tr>
<td>33</td>
<td>2007</td>
<td>Bharti Ventures Limited, India &amp; AXA Investment Managers (AXA IM) and AXA Asia Pacific Holdings.</td>
<td>Bharti AXA Mutual funds</td>
<td>Bharti AXA</td>
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<td>34</td>
<td>2007</td>
<td>Fidelity International Investment Advisors</td>
<td>FIDELITY Mutual funds</td>
<td>FIL Fund</td>
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<td>35</td>
<td>2008</td>
<td>Goldman Sachs Asset Management (GSAM)</td>
<td>Goldman Sachs Mutual funds</td>
<td>Goldman Sachs</td>
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<td>36</td>
<td>2008</td>
<td>IDFC Limited</td>
<td>IDFC Mutual funds</td>
<td>IDFC</td>
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<td>37</td>
<td>2008</td>
<td>Motilal Oswal Securities Limited</td>
<td>Motilal Oswal Mutual funds</td>
<td>Motilal Oswal</td>
</tr>
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<td>38</td>
<td>2009</td>
<td>Axis Bank Limited</td>
<td>AXIS Mutual funds</td>
<td>AXIS</td>
</tr>
<tr>
<td>39</td>
<td>2009</td>
<td>Peerless General Finance and</td>
<td>Peerless</td>
<td>Peerless</td>
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</tbody>
</table>
3.11.1 Mutual Funds and Wealth Creation

Mutual funds have generated higher returns than traditional savings products over longer time frames. Category-wise returns generated by mutual funds across time frames are as follows.

Table 3.6 – Category-Wise Returns on Mutual Funds

<table>
<thead>
<tr>
<th>Funds</th>
<th>3 Years (percent)</th>
<th>5 Years (percent)</th>
<th>7 Years (percent)</th>
<th>10 Years (percent)</th>
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</thead>
<tbody>
<tr>
<td>Equity Funds</td>
<td>23.80</td>
<td>8.19</td>
<td>18.93</td>
<td>25.46</td>
</tr>
<tr>
<td>Balance Funds</td>
<td>23.69</td>
<td>10.02</td>
<td>17.26</td>
<td>20.87</td>
</tr>
<tr>
<td>Income Funds</td>
<td>08.86</td>
<td>07.76</td>
<td>07.10</td>
<td>07.41</td>
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<tr>
<td>GILT Funds</td>
<td>04.65</td>
<td>05.99</td>
<td>05.83</td>
<td>07.25</td>
</tr>
</tbody>
</table>

Source: SEBI bulletins and SEBI Website and

Equity funds have given the highest returns followed by balance or hybrid funds. To enable optimal wealth creation, investors also need to look at asset allocation, i.e., investing across asset classes (equity, debt and gold) using principles of diversification to reduce the risk in the portfolio.
Overview of Mutual Funds

Table –3.7- List of Mutual Funds and Asset Managed as on September 2011

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Name of Mutual Funds</th>
<th>Average AUM (Rs in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AIG Mutual Funds</td>
<td>723</td>
</tr>
<tr>
<td>2</td>
<td>Axis Mutual Funds</td>
<td>7545</td>
</tr>
<tr>
<td>3</td>
<td>Baroda Pioneer Mutual Funds</td>
<td>3399</td>
</tr>
<tr>
<td>4</td>
<td>Bharti AXA Mutual Funds</td>
<td>176</td>
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Source: SEBI bulletins and SEBI Website and

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3.12 Frequently Used Terms in Mutual Funds Industry

For investors to become well aware about mutual funds, it is imperative for him or her to know the structure of a mutual funds, frequently used terms in mutual funds industry, how does a mutual funds come into being, who are the important people in a mutual funds, what are their roles, etc. Following section will describe fundamentals of mutual funds and frequently terms used in mutual funds industry.

3.12.1 Management of Investor’s Money

Trustees appoint the asset management company (AMC), to manage investor’s money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. The AMC’s board of directors must have at least 50 percent of directors who are independent directors. The AMC has to be approved by SEBI. The AMC functions under the supervision of its board of directors, and also under the direction of the trustees and SEBI. It is the AMC, which in the name of the trust, floats new schemes and manages these schemes by buying and selling securities. In order to do this the AMC needs to follow all rules and regulations prescribed by SEBI and as per the investment management agreement it signs with the trustees.

If any fund manager, analyst intends to buy/sell securities, the permission of the compliance officer is a must. A compliance officer is one of the most important persons in the AMC. Whenever the fund intends to launch a new scheme, the AMC has to submit a draft offer document to SEBI. This draft offer document, after getting SEBI approval becomes the offer document of the scheme. The offer document (OD) is a legal document and investors rely upon the information provided in the OD for investing in the mutual funds scheme. The compliance officer has to sign the due diligence certificate in the OD. This certificate says that all the information provided inside the OD is true and correct. This ensures that there is accountability and somebody is responsible for the OD. In case there is no compliance officer, then senior executives like CEO, Chairman of the AMC has to sign the due diligence certificate. The certificate ensures that the AMC takes responsibility of the OD and its contents.
3.12.2 Net Asset Value (NAV)

It is the popular and relevant term in mutual funds industry. It is the shares of each unit in the assets and securities of the scheme. NAV is calculated by dividing the aggregate value of the net assets of the scheme, by dividing the number of outstanding units under the scheme. The net assets represent the market value of the assets held by the fund, less the total liabilities and expenses including deemed transaction costs to realize the investments. NAV is normally calculated as follows.

\[
\text{NAV} = \frac{(M+O) - L}{U}
\]

Where:
- \(M\) = Market value of securities/investments made
- \(O\) = Other Assets
- \(L\) = Total Liabilities and
- \(U\) = Number of Units Outstanding. (Bansal, 2003)

The regulations 48 of the SEBI mutual funds regulations, 1996 requires that every mutual funds shall compute the NAV of each scheme by dividing the net assets of the scheme by the number of units outstanding on the valuation date and publish at least in two daily newspapers at intervals of not exceeding one week. All national newspapers publish the NAV of the schemes of all the mutual funds along with sale and repurchase prices. The securities shall be valued at the last quoted closing price on the stock exchange. When the securities are traded on more than one stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is mainly traded or where a majority in value of the investments are traded.

Once the stock exchange has been selected, reasons for change of the stock exchange shall be recorded in writing by the AMC. In case of non-traded securities or not traded for a period of 60 days prior to the valuation date, such securities shall be valued “in-good faith” by the AMC on the basis of appropriate valuation method approved by the board of the AMC. The methods used to value untraded securities “in-good faith” shall be periodically reviewed by the trustees and reported by the auditors as “fair and reasonable” in their report. The method of valuation of investments shall be in accordance with the valuation norms specified in eighth schedule to the SEBI mutual funds regulations, 1996.

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3.12.3 New Fund Offer (NFO)

Once the 3-tier structure is in place, the AMC launches new schemes, under the name of the trust, after getting approval from the trustees and SEBI. The launch of a new scheme is known as a New Fund Offer (NFO). It is like an invitation to the investors to put their money into the mutual funds scheme by subscribing to its units. When a scheme is launched, the distributors talk to potential investors and collect money from them by way of cheques or demand drafts. Mutual funds cannot accept cash. Mutual funds units can also be purchased on-line through a number of intermediaries who offer on-line purchase/redemption facilities. Before investing, it is expected that the investor reads the offer document (OD) carefully to understand the risks associated with the scheme.

3.12.4 Registrar and Transfer Agents

Registrars and Transfer Agents (RTAs) perform the important role of maintaining investor records. All the New Fund Offer (NFO) forms, redemption forms go to the RTA’s office where the information is converted from physical to electronic form. How many units will investor get, at what price, what is the applicable NAV, how much money will he get in case of redemption, exit loads, folio number, etc. is all taken care of by the RTA.

3.12.5 Open Ended and Close Ended Funds

Any mutual funds scheme can either be open ended or close ended. An open ended scheme allows the investor to enter and exit at his convenience, anytime except under certain conditions whereas a close ended scheme restricts the freedom of entry and exit. In case of open ended schemes, investors can buy the units even after the NFO period is over. Thus, when the fund sells units, the investor buys the units from the fund and when the investor wishes to redeem the units, the fund repurchases the units from the investor. This can be done even after the NFO has closed. The buy / sell of units take place at the Net Asset Value (NAV) declared by the fund.

The freedom to invest after the NFO period is over is not available in case of close ended schemes. Investors have to invest only during the NFO period. Once the NFO closes, new investors cannot enter, nor can existing investors exit, till the term of
the scheme comes to an end. However, in order to provide entry and exit option, close ended mutual funds list their schemes on stock exchanges. This provides an opportunity for investors to buy and sell the units from each other. This is just like buying/selling shares on the stock exchange. This is done through a stock broker. The outstanding units of the fund do not increase in this case since the fund is itself not selling any units. Sometimes, close ended funds also offer ‘buy-back of fund shares / units’, thus offering another avenue for investors to exit the fund. Therefore, regulations drafted in India permit investors in close ended funds to exit even before the term is over.

3.12.6 Equity Funds

Equity funds are defined as those funds which have at least 65 percent of their average weekly net assets invested in Indian equities. This is important from taxation point of view, as funds investing 100 percent in international equities are also equity funds from the investors’ asset allocation point of view, but the tax laws do not recognize these funds as equity funds and hence investors have to pay tax on the long term capital gains made from such investments which they do not have to pay in case of equity funds which have at least 65 percent of their average weekly net assets invested in Indian equities.

Equity funds come in various flavors and the industry keeps innovating to make products available for all types of investors. Relatively safer types of equity funds includes index funds and diversified large cap funds, while the riskier varieties are the sector funds. However, since equities as an asset class are risky, there is no guaranteeing returns for any type of fund. International funds, gold funds not to be confused with gold ETF and fund of funds are some of the different types of funds, which are designed for different types of investor preferences.

Equity funds can be classified on the basis of market capitalization of the stocks they invest in—namely large cap funds, mid cap funds or small cap funds – or on the basis of investment strategy the scheme intends to have like index funds, infrastructure fund, power sector fund, quant fund, arbitrage fund, natural resources fund, etc.
3.12.7 Index Funds
Index funds invest in stocks comprising indices, such as the NIFTY 50, which is a broad based index comprising 50 stocks. There can be funds on other indices which have a large number of stocks such as the CNX MIDCAP 100 or S&P CNX 500. Here the investment is spread across a large number of stocks. In India today we find many index funds based on the NIFTY 50 index, which comprises large, liquid and blue chip 50 stocks. The difference between the returns generated by the benchmark index and the index fund is known as tracking error. By definition, tracking error is the variance between the daily returns of the underlying index and the NAV of the scheme over any given period.

3.12.8 Diversified Large Cap Funds
Another category of equity funds is the diversified large cap funds. These are funds which restrict their stock selection to the large cap stocks – typically the top 100 or 200 stocks with highest market capitalization and liquidity. It is generally perceived that large cap stocks are those which have sound businesses, strong management, globally competitive products and are quick to respond to market dynamics. Therefore, diversified large cap funds are considered as stable and safe. However, since equities as an asset class are risky, there is no guarantee returns for any type of fund. These funds are actively managed funds unlike the index funds which are passively managed, in an actively managed fund the fund manager pores over data and information, the economy, analyses market trends, takes into account government policies on different sectors and then selects the stock to invest.

3.12.9 Midcap Funds
Midcap funds, which invest in stocks belonging to the mid cap segment of the market. Many of these midcaps are said to be the ‘emerging blue chips’ or ‘tomorrow’s large caps’. There can be actively managed or passively managed mid cap funds. There are indices such as the CNX midcap index which tracks the midcap segment of the markets and there are some passively managed index funds investing in the CNX midcap companies.
3.12.10 Sectorial Funds
Funds that invest in stocks from a single sector or related sectors are called sectorial funds. Examples of such funds are IT funds, pharmaceutical funds, infrastructure funds, etc. Regulations do not permit funds to invest over 10 percent of their net asset value in a single company. This is to ensure that schemes are diversified enough and investors are not subjected to undue risk.

3.12.11 Arbitrage Funds
These invest simultaneously in the cash and the derivatives market and take advantage of the price differential of a stock and derivatives by taking opposite positions in the two markets for e.g. stock and stock futures.

3.12.12 Multi-cap Funds
These funds can, theoretically, have a small cap portfolio today and a large cap portfolio tomorrow. The fund manager has total freedom to invest in any stock from any sector.

3.12.13 Quant Funds
A typical description of this type of scheme is that ‘the system is the fund manager’, i.e. there are some predefined conditions based upon rigorous back testing entered into the system and as and when the system throws ‘buy’ and ‘sell’ calls, the scheme enters, and/or exits those stocks.

3.12.14 P/E Ratio Funds
A fund which invests in stocks based upon their P/E ratios. Thus when a stock is trading at a historically low P/E multiple, the fund will buy the stock, and when the P/E ratio is at the upper end of the band, the scheme will sell.
3.12.15 **International Equity Funds**
This is a type of fund which investments in stocks of companies outside India. This can be a fund of fund, whereby, we invest in one fund, which acts as a ‘feeder’ fund for some other funds, i.e. invests in other mutual funds, or it can be a fund which directly invests in overseas equities. These may be further designed as ‘international commodities securities fund’ or ‘world real estate and bank fund’ etc.

3.12.16 **Growth Schemes**
Growth schemes invest in those stocks of companies whose profits are expected to grow at a higher than average rate. For example, telecom sector is a growth sector because many people in India still do not own a phone – so as they buy more and more cell phones, the profits of telecom companies will increase. Similarly, infrastructure; we do not have well connected roads all over the country, neither do we have best of ports or airports. For our country to move forward, this infrastructure has to be of world class. Hence companies in these sectors may potentially grow at a relatively faster pace. Growth schemes will invest in stocks of such companies.

3.12.17 **ELSS (Equity Linked Savings Scheme)**
Equity linked savings schemes are equity schemes, where investors get tax benefit up to Rs. 100,000 under section 80c of the income tax act. These are open ended schemes but have a lock in period of 5 years. These schemes serve the dual purpose of equity investing as well as tax planning for the investor; however it must be noted that investors cannot, under any circumstances, get their money back before 5 years over from the date of investment.

3.12.18 **Fund of Funds**
These are funds which do not directly invest in stocks and shares but invest in units of other mutual funds which they feel will perform well and give high returns. In fact such funds are relying on the judgment of other fund managers.
3.12.19 Expense Ratio
Among other things that an investor must look at before finalizing a scheme, is that he must check out the expense ratio.

3.12.20 Portfolio Turnover
Fund managers keep churning their portfolio depending upon their outlook for the market, sector or company. This churning can be done very frequently or may be done after sufficient time gaps. There is no rule which governs this and it is the mandate of the scheme and the fund managers’ outlook and style that determine the churning. However, what is important to understand is that a very high churning frequency will lead to higher trading and transaction costs, which may eat into investor returns. Portfolio turnover is the ratio which helps us to find how aggressively the portfolio is being churned.

While churning increases the costs, it does not have any impact on the expense ratio, as transaction costs are not considered while calculating expense ratio. Transaction costs are included in the buying & selling price of the scrip by way of brokerage, STT, CESS, etc.

3.12.21 Exit Loads
Exit loads, are paid by the investors in the scheme, if they exit one of the scheme before a specified time period. Exit loads reduce the amount received by the investor. Not all schemes have an exit load, and not all schemes have similar exit loads as well. Some schemes have contingent deferred sales charge (CDSC). This is nothing but a modified form of exit load, where in the investor has to pay different exit loads depending upon his investment period.

If the investor exits early, he will have to bear more exit load and if he remains invested for a longer period of time, his exit load will reduce. Thus the longer the investor remains invested, lesser is the exit load. After some time the exit load reduces to nil; i.e. if the investor exits after a specified time period, he will not have to bear any exit load.
3.12.22 Sale Price / Offer Price
Is the price customer pay when invest in a scheme. Also called offer price. It may include a sales load.

3.12.23 Repurchase Price / Bid Price
Repurchase price is the price at which a close-ended scheme repurchases its units and it may include a back-end load. This is also called Bid Price.

3.12.24 Redemption Price
Redemption price is the price at which open-ended schemes repurchase their units and close-ended schemes redeem their units on maturity. Such prices are NAV related.

3.12.25 Sales Load / Front End Load
Sales Load is a charge collected by a scheme when it sells the units. Also called, ‘front-end’ load. Schemes that do not charge a load are called ‘No Load’ schemes.

3.12.26 Repurchase or ‘Back-End’ Load
Repurchase or ‘Back-end’ Load is a charge collected by a scheme when it buys back the units from the unit holders.

3.12.27 Exchange Traded Funds
Exchange traded funds (ETFs) are mutual funds units which investors buy/ sell from the stock exchange, as against a normal mutual funds unit, where the investor buys / sells through a distributor or directly from the AMC. ETF as a concept is relatively new in India. It was only in early nineties that the concept gained in popularity in the USA. ETFs have relatively lesser costs as compared to a mutual funds scheme. This is largely due to the structure of ETFs. While in case of a mutual funds scheme, the AMC deals directly with the investors or distributors, the ETF structure is such that the AMC does not have to deal directly with investors or distributors. It instead issues units to a few designated large participants, who are also called as authorized participants (APs), who in turn act as market makers for the ETFs.
The authorized participants provide two way quotes for the ETFs on the stock exchange, which enables investors to buy and sell the ETFs at any given point of time when the stock markets are open for trading. ETFs therefore trade like stocks. Buying and selling ETFs is similar to buying and selling shares on the stock exchange. Prices are available on real time and the ETFs can be purchased through a stock exchange broker just like one would buy / sell shares. There are huge reductions in marketing expenses and commissions as the authorized participants are not paid by the AMC, but they get their income by offering two way quotes on the floor of the exchange. Practically any asset class can be used to create ETFs. Globally there are ETFs on silver, gold, etc. In India, ETFs on gold, indices such as NIFTY, bank NIFTY etc. are available.

3.12.28 Index ETF

An index ETF is one where the underlying is an index, say nifty. The APs deliver the shares comprising the nifty, in the same proportion as they are in the nifty, to the AMC and create ETF units in bulk. Once the APs get these units, they provide liquidity to these units by offering to buy and sell through the stock exchange. They give two way quotes, buy and sell quote for investors to buy and sell the ETFs. ETFs therefore have to be listed on stock exchanges. There are many ETFs presently listed on the NSE.

3.12.29 Gold ETF

Gold ETFs (G-ETFs) are a special type of ETF which invests in gold and gold related securities. This product gives the investor an option to diversify his investments into a different asset class, other than equity and debt. Traditionally, Indians are known to be big buyers of gold; an age old tradition. G-ETFs can be said to be a new age product, designed to suit traditional requirements. Holding physical gold can have its’ disadvantages such as fear of theft, payment wealth tax, no surety of quality, changes in fashion and trends, locker costs, lesser realization on remolding of ornaments etc.,

G-ETFs score overall some disadvantages, while at the same time retaining the inherent advantages of gold investing. In case of gold ETFs, investors buy units,
which are backed by gold. Thus, every time an investor buys 1 unit of G-ETFs, it is similar to an equivalent quantity of gold being earmarked for him somewhere. Thus his units are ‘as good as gold’. Say for example 1 G-ETF = 1 gm. of 99.5 percent pure gold, then buying 1 G-ETF unit every month for 20 years would have given the investor a holding of 240 gm. of gold, by the time his child’s marriage approaches (240 gm. = 1 gm./month*12 months * 20 years). After 20 years the investor can convert the G-ETFs into 240 gm. of physical gold by approaching the mutual funds or sell the G-ETFs in the market at the current price and buy 240 gm. of gold.

Secondly, all these years, the investor need not worry about theft, locker charges, quality of gold or changes in fashion as he would be holding gold in paper form. As and when the investor needs the gold, he may sell the units in the market and realize an amount equivalent to his holdings at the then prevailing rate of gold ETF. This money can be used to buy physical gold and make ornaments as per the prevailing trends. The investor will not have to pay any wealth tax on his holdings. There may be other taxes, expenses to be borne from time to time, which the investor needs to bear in mind while buying / selling g-ETFs.

The G-ETF is designed as an open ended scheme. Investors can buy/ sell units any time at the prevailing market price. This is an important point of differentiation of ETFs from similar open ended funds. In case of open ended funds, investors get units (or the units are redeemed) at a price based upon that day’s NAV. In case of ETFs, investors can buy (or sell) units at a price which is prevailing at that point of time during market hours. Thus for all investors of open ended schemes, on any given day their buying (or redemption) price will be same, whereas for ETF investors, the prices will vary for each, depending upon when they bought (or sold) units on that day.

3.12.30 Interest Rate Risk
Interest rate risk can be reduced by adjusting the maturity of the debt fund portfolio, i.e. the buyer of the debt paper would buy debt paper of lesser maturity so that when the paper matures, he can buy newer paper with higher interest rates. So, if the investor expects interest rates to rise, he would be better off giving short-term loans.
By giving a short-term loan, he would receive his money back in a short period of time. As interest rates would have risen by then, he would be able to give another loan (again short term), this time at the new higher interest rates. Thus in a rising interest rate scenario, investor can reduce interest rate risk by investing in debt paper of extremely short-term maturity.

3.12.31 Credit Risk

It refers to the situation where the borrower fails to honor either one or both of his obligations of paying regular interest and returning the principal on maturity. A bigger threat is that the borrower does not repay the principal. This can happen if the borrower turns bankrupt. This risk can be taken care of by investing in paper issued by companies with very high credit rating. The probability of a borrower with very high credit rating defaulting is far lesser than that of a borrower with low credit rating. Government paper is the ultimate in safety when it comes to credit risk. This is because the government will never default on its obligations. If the government does not have cash, it can print more money to meet its obligations or change the tax laws so as to earn more revenue.

3.12.32 Fixed Maturity Plans

FMPs have become very popular in the past few years. FMPs are essentially close ended debt schemes. The money received by the scheme is used by the fund managers to buy debt securities with maturities coinciding with the maturity of the scheme. There is no rule which stops the fund manager from selling these securities earlier, but typically fund managers avoid it and hold on to the debt papers till maturity. Investors must look at the portfolio of FMPs before investing. If an FMP is giving a relatively higher ‘indicative yield’, it may be investing in slightly riskier securities. Thus investors must assess the risk level of the portfolio by looking at the credit ratings of the securities. Indicative yield is the return which investors can expect from the FMP. Regulations do not allow mutual funds to guarantee returns, hence mutual funds give investors an idea of what returns can they expect from the fund. An important point to note here is that indicative yields are pre-tax. Investors will get lesser returns after they include the tax liability.
3.12.33 Capital Protection Funds
These are close ended funds which invest in debt as well as equity or derivatives. The scheme invests some portion of investor’s money in debt instruments, with the objective of capital protection. The remaining portion gets invested in equities or derivatives instruments like options. This component of investment provides the higher return potential.

3.12.34 Gilt Funds
These are those funds which invest only in securities issued by the government. This can be the central government or even state government. Gilt funds are safe to the extent that they do not carry any credit risk. However, it must be noted that even if one invests in government securities, interest rate risk always remains.

3.12.35 Balanced Funds/Hybrid Funds
These are funds which invest in debt as well as equity instruments. These are also known as hybrid funds. Balanced does not necessarily mean 50:50 ratio between debt and equity. There can be schemes like MIPs or children benefit plans which are predominantly debt oriented but have some equity exposure as well. From taxation point of view, it is important to note how much portion of money is invested in equities and how much in debt.

3.12.36 Monthly Investment Plan (MIPs)
Monthly income plans (MIPs) are hybrid funds; i.e. they invest in debt papers as well as equities. Investors, who want a regular income stream, invest in these schemes. The objective of these schemes is to provide regular income to the investor by paying dividends; however, there is no guarantee that these schemes will pay dividends every month. Investment in the debt portion provides for the monthly income whereas investment in the equities provides for the extra return which is helpful in minimizing the impact of inflation.
3.12.37 Child Benefit Funds
These are debt oriented funds, with very little component invested into equities. The objective here is to capital protection and steady appreciation as well. Parents can invest in these schemes with a 5 to 15 year horizon, so that they have adequate money when their children need it for meeting expenses related to higher education.

3.12.38 Liquid Funds
By far the biggest contributor to the mutual funds industry, liquid funds attract a lot of institutional and high net-worth individuals (HNI) money. It accounts for approximately 40 percent of industry AUM. Less risky and better returns than a bank current account are the two plus points of liquid funds.

3.12.39 Systematic Investment Plan (SIP)
The Systematic Investment Plan (SIP) is a simple and time honored investment strategy for accumulation of wealth in a disciplined manner over long term period. The plan aims at a better future for its investors as an SIP investor gets good rate of returns compared to a one time investor. In SIP a specific amount should be invested for a continuous period at regular intervals. SIP ensures averaging of rupee cost as consistent investment ensures that average cost per unit fits in the lower range of average market price. An investor can either give postdated cheques or ECS instruction and the investment will be made regularly in the mutual funds desired for the required amount. SIP generally starts at minimum amounts of Rs.1000/- per month and upper limit for using an ECS is Rs.25000 per instruction. For instance, if one wishes to invest Rs.100000 per month, then they need to do it on four different dates. SIP provides different benefits such as power of compounding, rupee cost averaging, convenience etc.

3.12.40 Systematic Transfer Plan (STP)
STP refers to Systematic Transfer Plan where in an investor invests a lump sum amount in one scheme and regularly transfers i.e. switches a pre-defined amount into another scheme. Every month on a specified date an amount investor chooses is transferred from one mutual funds scheme to another of investor choice. Currently,
Fixed Systematic Transfer Plan (FSTP) - Monthly Interval and Capital Appreciation Systematic Transfer Plan (CASTP) are available.

3.12.41 Systematic Withdrawal Plan (SWP)
SWP stands for systematic withdrawal plan. Here investor invests a lump sum amount and withdraws some money regularly over a period of time. This results in a steady income for the investor while at the same time his principal also gets drawn down gradually. For example an investor aged 60 years receives Rs. 2000000 at retirement. If he wants to use this money over a 20 year period, he can withdraw Rs. 2000000/20 = Rs. 100000 per annum. This translates into Rs. 8333 per month. The investor will also get return on his investment of Rs. 2000000, depending on where the money has been invested by the mutual funds.

The conceptual difference between SWP and MIP is that SWP is an investment style whereas MIP is a type of scheme. In SWP the investor’s capital goes down whereas in MIP, the capital is not touched and only the interest is paid to the investor as dividend.

3.13 Need for Mutual Funds Act
UTI was set up under the UTI act, 1963. The act is comprehensive and provides for all matters connected with organization and management of its business. This act is not applicable to other mutual funds. With the establishment of SEBI under the SEBI act, 1992, all other mutual funds were brought under the regulatory purview of SEBI. SEBI tried for a long time to bring UTI under its purview. In a significant judgment on a petition filled by Kinetic Engineering Limited, “The company law board is one of the opinions that UTI is a mutual fund to which SEBI regulations are not applicable (Singh, 2001).” As a result of further efforts on both the sides, an arrangement was worked out between SEBI and UTI, whereby UTI has voluntarily agreed to comply with SEBI regulations for certain schemes only.

In the absence of a single comprehensive legislation for mutual funds, there are several acts applicable to the business of mutual funds. There should be a specific mutual funds act in order to avoid overlapping of various provisions of Indian trusts
act, the companies act and SEBI regulations. The public sector banks adopted the trust route instead of companies incorporated under the companies act, 1956. “A mutual funds set up as a company would be in a situation of multiple regulatory purview of SEBI and the department of company affairs of the government of India. This could have caused hardship and hampered the healthy growth of the emerging mutual funds industry.

The SEBI (mutual funds) regulations, 1993, therefore stipulated the setting up of the mutual funds as trusts under the Indian trusts act, 1882.” The mutual funds set up as trustees under the Indian trusts act, 1882 have been facing certain legal and practical problems as the act was not enacted for mutual funds. The act does not contain adequate provisions to deal with a trust where there is a large scale mobilization of public funds for expert fund management to maximize investor value as the act deals with property entrusted by a settler in the hands of trustees for the benefits of beneficiaries. Here the investors are settlers and beneficiaries both. The management of funds has been entrusted to the asset management companies incorporated under the company’s act, 1956 to separate management from ownership, control and supervision.

There are several parties to mutual funds such as sponsor, trustees, asset management company, custodian and the investors as beneficiaries. The rights, duties and obligations of all the parties need to be focused under a specific statute or act rather than enforcing partly under SEBI act, the companies act, and the Indian trusts act. Some mutual funds have opted to constitute a trustee company under the companies act. “There is the issue of individual or collective liability of trustees in a board of trustees and of directors in a trustee company. The provisions of the Indian trusts act prohibit the limiting or extinguishing of the obligations and liabilities of the trustees or indemnifying them for loss or damages (SEBI, 2011).” Thus, the liabilities of the trustees are not limited whereas the directors of the trustee company are indemnified for any loss or damages for the same duties and responsibilities. There is a need to harmonies the duties and responsibilities of the directors of a trustee company with the trustees under the companies act and the Indian trusts act to protect the interests of the investors.

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The Indian trusts act does not permit perpetual succession. Under the trusts act read with the transfer of properties act, there is a rule against perpetuity. While the companies act permits perpetual succession, but it can’t protect the interests of the investors due to the privilege of limited liability available to the companies incorporated under the companies act. Hence, mutual funds can’t be structured as investment companies. The properties can’t be registered in the name of the trust as the trust is not a legal entity or person in the eyes of the law. Such properties are required to be registered in the names of the trustees but whenever there is any change in the trustees, the properties are required to be registered in the names of new trustees involving payment of stamp duty and other legal expenses. Hence, many mutual funds have opted to incorporate a trustee company under the companies act, with perpetual succession and capable of entering into contracts, being sued and sue others in its own name and capable of holding properties in its own name as legal entity.

The investments held by the mutual funds in the form of shares and debentures of other companies can’t be registered or transferred in the name of the mutual funds and are subject to declaration of beneficial interest under section 187C of the companies Act. The ownership of the trustee company and asset management company is exclusively with the sponsors on the boards of both the companies. It is extremely complex to maintain the independence of the outside or independent directors in the working of such boards. There is no control on the sponsors of mutual funds.

The investors have no voting powers like shareholders of companies, so they can’t exercise any control on the management and control of the mutual funds. The government of India should consider enacting a separate comprehensive act for mutual funds and clearly spell out rights, duties, and obligations of the various constituents of the mutual funds such as sponsor, trustees, asset management company, custodian, registrar, etc. A single act will provide a uniform regulatory framework for all mutual funds including UTI mutual funds governed by UTI act which could be repealed through the mutual funds act. The act would avoid overlapping provisions of the companies act, India trusts act and SEBI (mutual funds) regulations. The mutual funds would be required to play a critical role in the development of healthy capital markets. It may be expedient to have an independent

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statute for mutual funds as it would also give due recognition of their role in the
development of capital markets.

Mr. R.S. Bhatt (1996), founder chairman of UTI had also expressed the need for a
common legislation both for UTI and other mutual funds. “As Indian mutual funds
business falls within the set of business pursued by UTI, there should be a common
legislation both for UTI and other mutual funds. By and large it would appear that
UTI act may be suitably amended to accommodate the mutual funds in India.”

As the investment in mutual fund industry is growing every year and considering to
the future perspectives in mutual funds industry, researcher has selected mutual funds
product for further in-depth analysis.