

A CONCEPTUAL OVERVIEW OF MUTUAL FUNDS IN INDIA

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ABSTRACT

Mutual funds are Financial Intermediaries concerned with mobilising savings of those who have surplus income and channelisation of these savings in those avenues where there is demand of funds. These institutions employ their resources in such a manner as to afford for their investors the combined benefits of low risk, steady return, high liquidity and capital appreciation through diversification and expert management. By playing the role of financial intermediation mutual funds provide a convenient and effective link between savings and investment. Well managed mutual funds would be mutually beneficial arrangement. While, on the one hand, they help the investing community by offering share of corporate growth, on the other they have a salutary impact on the stock markets. By blending caution with aggression and analysis with intuition, the funds can successfully convert market opportunities into lucrative returns for the investors.

KEYWORD

Performance, Mutual Funds, CRISIL, Credit Rating Agency

INTRODUCTION

Mutual fund is an American concept and the terms, 'Investment Trust', 'Investment company', 'Mutual fund', 'Money Fund' etc., are used interchangeably in American literature. Mutual funds are corporations which accept dollars to buy stocks, long-term bonds, short-term debt instruments issued by business or government units. These corporations pool funds and thus, reduce risk by diversification. The term 'mutual' signifies that all gains or losses resulting from the investment accrue to all the investors in proportion to their subscription. Mutual fund is, thus, a concept of mutual help of the subscribers for portfolio investment and management of these investments by experts in the field.

Investment company institute, USA defines the term mutual fund as a type of investment company that gathers assets from investors and collectively invests those assets in stock, bonds or money market instruments.

Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 defines mutual fund as a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments.

Mutual fund generally refers to open-end investment trusts whose distinctive feature is regular sale and purchase of securities. Further, mutual funds must redeem their shares at the funds current net asset value at the time the shareholders request redemption.

Savers of moderate means in the underdeveloped regions are generally reluctant to invest in corporate securities because of their lack of adequate knowledge about complicated investment affairs. Moreover, their resources being small, they can at best hold securities of one or two or just a few industrial concerns only and as such, the fate of their savings and prospects of earnings therefrom are tied to the fate of such unit or units. Investment in securities of mutual funds takes care of both these problems, for such investment,

in effect, represents a part of the funds entire portfolio diversified in terms of securities, units, industries and geographical regions. These institutions employ expert investment analysts and thus professional knowledge and expertise go into the selection and supervision of their investment portfolio. Diversification and expert investment knowledge ensure steady and regular earnings to the fund and a share in the general prosperity. Accordingly, investors in the shares of mutual funds are assured of low risk, steady return, liquidity and capital appreciation. By taking upon themselves the problems which confront the small savers in investing their savings and dealing with them effectively, mutual funds help mobilise savings of the people and promote thrift.

Mutual funds also provide benefits of flexibility in as much as investors can systematically invest or withdraw funds, or switch to other schemes according to their needs, through features provided under their different schemes, such as regular investment, withdrawal plans and dividend reinvestment options. Tax benefits to investors in certain schemes constitute an added attraction for mutual funds. Dividends paid by mutual funds to unit holders are taxed only at the time of distribution of dividends. These dividends after this deduction are tax-free in the hands of investors. On the contrary, investment in bonds or other deposits that earn interest is taxed at 30 per cent.

OBJECTIVES & RESEARCH METHODOLOGY

The purposes of conducting this study are enumerated as follows:

1. To understand the evolution and growth of mutual funds industry in India.
2. To understand the policies and strategies of mutual funds in India.
3. To get an insight into how to invest in mutual funds.

The study is purely based on secondary data which is collected through various books, articles and research papers published in different national and international journals and various websites.

EVOLUTION & GROWTH OF MUTUAL FUNDS

The history of mutual funds dates back to nineteenth century Europe, in particular, Great Britain. Robert Fleming set up, in 1868, the first investment trust called Foreign and Colonial Investment Trust which promised to manage the finances of the moneyed classes of Scotland by spreading the investment over a number of different stocks. Innovations in products and services increased the popularity of mutual funds in the 1950s and 1960s. The first international stock mutual fund was introduced in the US in 1940. In 1976, the first tax-exempt municipal bond funds emerged and in 1979, the first money market mutual funds were created. This industry witnessed substantial growth in the 1980s and 1990s when there was a significant increase in the number of mutual funds, schemes, assets, and shareholders.

Growth of Mutual Funds in India

The Indian mutual fund industry has evolved over distinct stages. The growth of the mutual fund industry in India can be divided into four phases: Phase I (1964-87), Phase II (1987-92), Phase III (1992-97), and Phase IV (beyond 1997).

Phase I The mutual fund concept was introduced in India with the setting up of UTI in 1963. The Unit Trust of India (UTI) was the first mutual fund set up under the UTI Act, 1963, a special act of the parliament. It became operational in 1964 with a major objective of mobilizing savings through the sale of units and investing them in corporate securities for maximizing yield and capital appreciation. This phase commenced with the launch of the Unit Scheme 1964 (US-64), the first open-ended and the most popular scheme.

Phase II The second phase witnessed the entry of mutual fund companies sponsored by nationalized banks and insurance companies. In 1987, SBI Mutual Fund and Canbank Mutual Fund were set up as trusts under the Indian Trust Act, 1882. In 1988, UTI floated another offshore fund, namely, The India Growth Fund which was listed on the New York Stock Exchange (NYSE). By 1990, the two nationalized insurance giants, LIC and GIC, and nationalized banks, namely, Indian Bank, Bank of India, and Punjab National Bank had started operations of wholly-owned mutual fund subsidiaries. The assured return type of schemes floated by the mutual funds during this phase were perceived to be another banking product offered by the arms of

sponsor banks. In October 1989, the first regulatory guidelines were issued by the RBI, but they were applicable only to the mutual funds sponsored by banks. Subsequently, the Government of India issued comprehensive guidelines in June 1990 covering all mutual funds. These guidelines emphasized compulsory registration with the SEBI and an arms-length relationship be maintained between the sponsor and asset management company (AMC).

Phase III The year 1993 marked a turning point in the history of mutual funds in India. The Securities and Exchange Board of India (SEBI) issued the Mutual Fund Regulations in January 1993. The SEBI notified regulations bringing all mutual funds except UTI under a common regulatory framework. Private, domestic and foreign players were allowed entry in the mutual fund industry. The Kothari group of companies, in joint venture with Pioneer, a US fund company, set up the first private mutual fund, the Kothari Pioneer Mutual Fund, in 1993. Kothari Pioneer introduced the first open-ended fund Prima in 1993. Several other private sector mutual funds were set up during this phase.

Phase IV During this phase, the flow of funds into the kitty of mutual funds sharply increased. This significant growth was aided by a more positive sentiment in the capital market, significant tax benefits, and improvement in the quality of investor service. Investible funds, at market value, of the industry rose by June 2000 to Over 1,10,000 crore with UTI having a 68 per cent of the market share. The Unit Trust of India lost out to other private sector players during this period. While there was an increase in asset under management (AUM) by around 11 per cent during the year 2002, UTI, on the contrary, lost more than 11 per cent in AUM. The private sector mutual funds have benefited the most from the debacle of US-64 of UTI. The AUM of this sector grew by around 60 per cent for the year ending March 2002. There was a record growth in funds mobilized through a record number of new Schemes during the year 2004-05. In the last decade, the mutual fund industry has shown impressive growth not just in the scale of AUM but also in terms of schemes and products.

POLICIES AND STRATEGIES OF MUTUAL FUNDS IN INDIA

Mutual funds in India seem to have pursued policy of raising their resources from corporate sector. This is more so in the case of private sector and joint sector funds that confine their operations in metropolitan and other big cities. To attract resources from corporate sector customized schemes are brought out frequently. In recent years, they are drifting towards retail investors so as to widen their customer base. For mobilization of resources the industry's strategy is to employ agents and distributors, train and develop their skills so that they can educate the investors properly and offer them suitable products to meet their requirements. Rationalization of product distribution arrangements, continuous R & D for improving product handling and phased shift from scheme-oriented investor services to single window personalized client-oriented services are the hallmarks of Indian mutual funds' strategies. The crux of investment policy of mutual funds is management of its portfolio assets, consisting primarily of industrial securities. Management, therefore, requires constant vigilance over the trends emerging in the financial markets. The broad aim of the investment strategy should, therefore, be to maximize income on the portfolios as a whole, given the conditions in the capital and stock markets.

In formulating investment strategy, the management is guided mainly by considerations of the safety of funds, reasonable return and capital appreciation on the security instruments. Most of the funds have decided to build and maintain a balanced portfolio, comprising both variable dividend and fixed income-yielding securities so as to strike a proper balance between the two fundamental principles of the safety of the principal and return on capital. Marketability of the securities is an important consideration for the mutual funds in India so that investors may avail the benefits of capital appreciation and a reasonably high return on their investments. In their endeavour to ensure security of capital and a reasonable return, mutual funds in India have adopted the principle of diversification. A ceiling in terms of proportion of the resources to be deployed in an individual company and industry is fixed, keeping in view the SEBI framework. In view of immense potentiality of infrastructural sector in the economic development of India and the concomitant government policy directives to financial institutions, public sector mutual funds have recently decided to invest in equity issues of infrastructural projects.

HOW TO INVEST IN A SCHEME OF MUTUAL FUND?

Every month, fund houses come up with new schemes. It is on the investor to decide whether to invest in an existing scheme or a new fund offering of a mutual fund. Whenever a new scheme is to be launched by a fund house, it is advertised in newspapers. The investor has to fill up an application form to subscribe to a scheme. Mutual funds appoint agents and distributors to provide services such as distribution of application forms, providing information about the scheme and giving investment advice. Nowadays, banks and post offices also help in distribution of mutual funds scheme to investors. An investor can also approach the respective offices of the mutual funds called Investor Service Centres (SCS) in his particular town or city.

Investment in mutual fund is not free from risks. All investments in mutual fund and securities are subject to market risks and the NAVs of the schemes may go up or down depending upon the factors and forces affecting the securities market including the fluctuations in the interest rates. Besides the NAV, the investor should look at average returns and volatility of the returns given by the fund. A fund giving consistent returns is better than a fund whose returns are highly volatile. Moreover, the returns given by the fund should be compared with benchmarks like BSE Sensex and S&P Nifty. An investor should also study the past performance track record of the scheme and also compare its performance with other schemes having similar investment objectives. The past performance of the mutual fund is not necessarily indicative of future performance of the scheme. He should also look at the quality of the scheme portfolio, i.e., investment made in each security such as equity, debentures, money market instruments and government securities, their quantity, market value, and percentage to NAV. In case of debt-oriented scheme, he should also look into the rating of the debt instrument. An investor should also check whether the scheme is open-ended or close-ended. If it is a close-ended scheme, he may have to pay an exit load. When choosing a fund, an investor should also look into the expense ratio- the cost he pays towards the services he avails of from mutual funds. A high expense ratio lowers the rate of return of schemes and a lower expense ratio boosts the rate of return. For debt funds and index funds, expense ratio is more important. He may also consult financial experts or read financial dailies which publish research reports on performance of mutual funds.

Apart from assessing the risk profile of the scheme, an investor should also take into account his risk-taking capacity, objective of investment, time period of investment, age, lifestyle, and cash flow requirements before making a choice of particular scheme. Asset allocation, which is a function of risk appetite and goals, contributes more than 90 per cent to the portfolio's returns. A young investor with an above average risk appetite may go for growth-oriented scheme or an investor nearing retirement may prefer debt-oriented scheme or fixed maturity plans. If an investor prefers cash flow at regular intervals, he may look at dividend plans as most give pay-outs at least once a year. Mutual funds should be looked at from a medium-term to long-term perspective and investors need to go for a careful combination of different themes and sectors. Investors should design a well-balanced portfolio and rebalance it on a regular basis.

CONCLUSION

Role of the mutual funds is not limited to domestic sphere only. In addition to attracting domestic savings, these funds can offer their units abroad and attract foreign capital just as UT has recently done by offering India Fund, India Growth Fund schemes. Similarly, they may serve as useful institutions for securing profitable investment avenues abroad for domestic savings. Investment in foreign industrial securities requires fairly detailed knowledge of the state of the foreign economy in general and of industries in particular as also of fiscal position of industrial enterprises and their future prospects. As a result, despite attractive investment prospects abroad for surplus domestic savings, individual investors would find it an extremely difficult task to make foreign investment on their own. Mutual funds have, as in the case of domestic investment, stepped in to solve these problems for the savers.

Mutual fund is a financial intermediary concerned with garnering savings of the people to invest in a diversified portfolio of securities with a view to ensuring the savers triple benefits of minimum risk, steady return and capital appreciation to tighten governance and disclosure rules and develop effective monitoring system to curb the existing unethical practices. Mutual funds are of various types evolved to cater to the

varying needs and preferences of large number of savers across the country and abroad. Thus, there may be different categories of mutual funds based on functional, portfolio and geographical types.

So as to ensure smooth functioning of mutual funds, the Government, RBI and SEBI have laid down policy guidelines, However, these guidelines have not been enforced effectively leading to a number of unethical practices by the mutual funds to the detriment of the retail investors. As regards performance of mutual funds, private sector and joint sector funds have played crucial role in mopping up savings of public, accounting for about 70 per cent of the total resources garnered so far by the mutual funds. Among the various saving schemes, liquid/money market schemes and grown/equity-oriented schemes have been very popular. Further, open-end schemes have had edge Over close-end schemes in attracting savings. It is intriguing to find that mutual funds in India have become vehicles of power and privileges, doing all sorts of favour to a few institutional/High Net Income (HN) investors at the expense of retail investors. In connivance with mutual funds managers and corporate and HNI investors have engaged in numerous unethical practices such as late trading, rapid trading, dominance of fund by a single or few large investors, diversion of funds, etc. mutual funds have also been found splurging on marketing expenses. Although mutual funds in India have bright future because of surging economy and robust industrial growth, the Government, RBI and SEBI need to tighten governance and disclosure rules and develop effective monitoring system to curb the existing unethical practices.

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