15

Mutual Funds

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1 *Meaning and benefits of mutual funds*
2 *History of mutual funds*
3 *Growth of mutual funds in India*
4 *Types of mutual fund schemes*
5 *Net asset value*
6 *Organization of a mutual fund*
7 *SEBI guidelines relating to mutual funds*
8 *Association of mutual funds in India*
9 *Unit Trust of India and US-64*
10 *Growth and performance of mutual funds in India*

INTRODUCTION

A mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is 'mutual' as all of its returns, minus its expenses, are shared by the fund's investors.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a 'a fund established in the form of a trust to raise money 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 or gold or gold related instruments or real estate assets'.

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be set up in the form of a trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

- Portfolio management services
- Management of offshore funds
- Providing advice to offshore funds
- Management of pension or provident funds
- Management of venture capital funds
- Management of money market funds
- Management of real estate funds

A mutual fund serves as a link between the investor and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders.

Mutual funds in India are not much different from portfolio managers for select corporates and high net worth individuals whose collective share in MF investment is more than 80 per cent.

Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilizing the savings of small investors and channelizing the same for productive ventures in the Indian economy. Mutual fund is similar to a collective investment scheme (CIS) which pools the savings and invests them to generate returns. While mutual fund invests in securities, CIS invests only in plantations, real estate and art funds.

Benefits of Mutual Funds

An investor can invest directly in individual securities or indirectly through a financial intermediary. Globally, mutual funds have established themselves as the means of investment for the retail investor.

Professional Management An average investor lacks the knowledge of capital market operations and does not have large resources to reap the benefits of investment. Hence, he requires the help of an expert. It is not only expensive to hire the services of an 'expert' but it is more difficult to identify a real expert. Mutual funds are managed by professional managers who have the requisite skills and experience to analyse the performance and prospects of companies. They make possible an organized investment strategy, which is hardly possible for an individual investor.

Portfolio Diversification An investor undertakes risk if he invests all his funds in a single scrip. Mutual funds invest in a number of companies across various industries and sectors. This diversification reduces the riskiness of the investments.

Reduction in Transaction Costs Compared to direct investing in the capital market, investing through the funds is relatively less expensive as the benefit of economies of scale is passed on to the investors.

Liquidity Often, investors cannot sell the securities held easily, while in case of mutual funds, they can easily encash their investment by selling their units to the fund if it is an open-ended scheme or selling them on a stock exchange if it is a close-ended scheme.

Convenience Investing in mutual fund reduces paperwork, saves time and makes investment easy.

Flexibility Mutual funds offer a family of schemes, and investors have the option of transferring their holdings from one scheme to the other.

Tax Benefits Mutual fund investors now enjoy income tax benefits. Dividends received from mutual funds' debt schemes are tax exempt to the overall limit of ₹1,00,000 allowed under section 80C of the Income Tax Act.

Transparency Mutual funds transparently declare their portfolio every month. Thus, an investor knows where his/her money is being deployed and in case they are not happy with the portfolio they can withdraw at a short notice.

Stability to the Stock Market Mutual funds have a large amount of funds which provide them economies of scale by which they can absorb any losses in the stock market and continue investing in the stock market. In addition, mutual funds increase liquidity in the money and capital market.

Equity Research Mutual funds can afford information and data required for investments as they have large amount of funds and equity research teams available with them.

Protection of Interest of Investors Being regulated by SEBI, mutual funds have to adhere to the strict regulation designed to protect the interest of the investors.

HISTORY 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. This investment trust and other investment trusts which were subsequently set up in Britain and the US, resembled today's close-ended mutual funds. The first mutual fund in the US, Massachusetts Investors' Trust, was setup in March 1924. This was the first open-ended mutual fund.

The stock market crash in 1929, the Great Depression, and the outbreak of the Second World War slackened the pace of growth of the mutual fund industry. 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. The latest additions are the international bond fund in 1986 and arm funds in 1990. 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. In the US, the mutual fund industry registered a tenfold growth in the 1980s (1980–89) only, with 25 per cent of the household sector's investment in financial assets made through them. Fund assets increased from less than USD 150 billion in 1980 to over USD 4 trillion by the end of 1997. Since 1996, mutual fund assets have exceeded bank deposits. The mutual fund industry and the banking industry virtually rival each other in size.

Box 15.1 Difference Between Stock IPO and MF IPO

Investors tend to equate a mutual fund IPO with a stock IPO. In a stock IPO, shares are allotted at a price arrived at through the book building process. They are then listed on a stock exchange/for trading. The price of the newly listed share is determined by the demand-supply forces at the time of listing resulting either in discount, par or premium price listing. Hence, the listing price may differ from the price at which the shares were offered at the time of subscription, allowing investors a chance to make money on listing. However, in the case of a mutual fund IPO, units are issued at a face value of ₹10 at the time of launching a scheme. The scheme then reopens for continuous sale and repurchase which is based on the net asset value (NAV). The NAV reflects the latest market value of the underlying assets in which the funds are invested. In other words, the price of each unit is linked to the market price of underlying assets and not to the demand-supply forces. An MF scheme, usually opens below par as new schemes often charge an entry load at the time of subscription which is a cost to the investor. Due to this load, the NAV of the fund opens lower than the par value. The fund managers also adjust initial issue expenses to the fund NAV and as a result of this, the opening NAV falls below the par value. Thus, it is possible that an investor in a mutual fund IPO may not immediately make money when the scheme reopens for sale and repurchase. The value of the securities fluctuates everyday and this impacts the value (NAV) of the mutual fund unit. Therefore, unlike shares, the demand or supply of MF units do not influence its post-issue value.

An investor receives dividend on his investment in stocks and mutual fund. The amount of dividend payment reduces the value of both stocks and units. However, a mutual fund dividend is not the same thing as a stock dividend. In the case of stock, it may quote at a price higher than cum-dividend price immediately after the dividend has been paid because it is the market forces which determine the share price, thus, resulting in an increase in shareholder wealth. But, in the case of open-ended funds, the unit NAV being solely determined by the value of the underlying securities reduces with the outflow of dividend and increases only when the value of the underlying securities rises. Thus, the unitholder's wealth may not increase immediately after the dividend payment.

SEBI has directed mutual funds to term their new scheme launches as 'new scheme offerings' or 'new fund offerings' instead of IPOs.

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. UTI's investible funds, at market value (and including the book value of fixed assets) grew from ₹49 crore in 1965 to ₹219 crore in 1970–71 to ₹1,126 crore in 1980–81 and further to ₹5,068 crore by June 1987. Its investor base had also grown to about two million investors. It launched innovative schemes during this phase. Its fund family included five income-oriented, open-ended schemes, which were sold largely through its agent network built up over the years. Master share, the equity growth fund launched in 1986, proved to be a grand marketing success. Master share was the first real close-ended scheme floated by UTI. It launched the India Fund in 1986—the first Indian offshore fund for overseas investors, which was listed on the London Stock Exchange (LSE). UTI maintained its monopoly and experienced a consistent growth till 1987.

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). With the entry of public sector funds, there was a tremendous growth in the size of the mutual fund industry with investible funds, at market value, increasing to ₹53,462 crore and the number of investors increasing to over 23 million. The buoyant equity markets in 1991–92 and tax benefits under equity-linked savings schemes enhanced the attractiveness of equity funds.

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. UTI launched a new scheme, Master-gain, in May 1992, which was a phenomenal success with a subscription of ₹4,700 crore from 63 lakh applicants. The industry's investible funds at market value increazed to ₹78,655 crore and the number of investor accounts increased to 50 million. However, the year 1995 was the beginning of the sluggish phase of the mutual fund industry. During 1995 and 1996, unitholders saw an erosion in the value of their investments due to a decline in the NAVs of the equity funds. Moreover, the service quality of mutual funds declined due to a rapid growth in the number of investor accounts, and the inadequacy of service infrastructure. A lack of performance of the public sector funds and miserable failure of foreign funds like Morgan Stanley eroded the confidence of investors in fund managers. Investors perception about mutual funds, gradually turned negative. Mutual funds found it increasingly difficult to raise money. The average annual sales declined from about ₹13,000 crore in 1991–94 to about ₹9,000 crore in 1995 and 1996.

- A mutual fund can invest money mobilized under any of its schemes only in:
  – securities
  – money market instruments
  – privately placed debentures
  – securitized debt instruments backed by assets
  – gold or gold related instruments

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. During 1999– 2000 sales mobilization reached a record level of ₹73,000 crore as against ₹31,420 crore in the preceding year. This trend was, however, sharply reversed in 2000–01. The UTI dropped a bombshell on the investing public by disclosing the NAV of US-64—its flagship scheme as on December 28, 2000, just at ₹5.81 as against the face value of ₹10 and the last sale price of ₹14.50. The disclosure of NAV of the country's largest mutual fund scheme was the biggest shock of the year to investors. Crumbling global equity markets, a sluggish economy coupled with bad investment decisions made life tough for big funds across the world in 2001–02. The effect of these problems was felt strongly in India also. Pioneer ITI, JP Morgan, and Newton Investment Management pulled out from the Indian market. The Bank of India MF liquidated all its schemes in 2002.

The Indian mutual fund industry stagnated at around ₹1,00,000 crore assets during the years 2000– 01 and 2001–02. This stagnation was partly a result of stagnated equity markets and an indifferent performance by players. As against this, the aggregate deposits of scheduled commercial banks (SCBs) as on May 3, 2002, stood at ₹11,86,468 crore. Mutual funds assets under management (AUM) form just around 10 per cent of deposits of SCBs.

The Unit Trust of India lost out to other private sector players during this period. While there was an increase in 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. Buoyed by robust capital inflows and strong participation of retail investors, the asset base of the mutual fund industry again produced record breaking numbers in 2016–17. As of June 30, 2017, the total AUM of the sector stood at ₹19,51,775 crore. The AUM of the industry saw a lucrative year-on-year growth of 42.3 per cent in the year ending March, 2017. However, AUM to GDP (₹151.83 lakh crore at current prices) ratio of 12.8 per cent indicates a large untapped market potential and very low penetration vis-a-vis global and peer benchmarks.

MUTUAL FUND CONCEPTS

Net Asset Value

- Net asset value of a scheme reflects the performance of the scheme on a day-to-day basis.

The net asset value of a fund is the market value of the assets minus the liabilities on the day of valuation. In other words, it is the amount which the shareholders will collectively get if the fund is dissolved or liquidated. The net asset value of a unit is the net asset value of fund divided by the number of outstanding units.

Thus NAV = Market price of securities + Other assets − Total liabilities/units outstanding as at the NAV date.

NAV = Net assets of the scheme/Number of units outstanding, *i.e.*, Market value of investments + Receivables + Other Accrued Income + Other assets – Accrued expenses – Other payables – Other liabilities/ No. of units outstanding as at the NAV date.

A fund's NAV is affected by four sets of factors: purchase and sale of investment securities, valuation of all investment securities held, other assets and liabilities, and units sold or redeemed.

The following recurring expenses are charged directly to the scheme which affects its NAV:

- Marketing and selling expenses (including distributors' fees).
- Brokerage charges.
- Registration charges.
- Audit fees.
- Custodian fees.
- Expenses on investors' communication.
- Insurance premium paid by the fund.
- Cost of statutory advertisement.

- Net Asset Value is the market value of the assets of the scheme minus its liabilities

Certain expenses are not charged to the scheme and hence do not affect the NAV. They are:

- Penalties and fines for violation of law.
- Interest on late payment to unit holders.
- Legal, marketing, publication and general expenses not attributed to any schemes.
- Expenses on investment management and general management.
- Depreciation on fixed assets and software development expenses.

- Net asset value is the price at which an investor can buy or sell a unit of a mutual fund scheme

The SEBI has issued guidelines on valuation of traded securities, thinly traded securities, and nontraded securities. These guidelines were issued to streamline the procedure of calculation of NAV of the schemes of mutual funds. The aggregate value of illiquid securities as defined in the guidelines shall not exceed 15 per cent of the total assets of the scheme and any illiquid securities held above 15 per cent of the total assets shall be valued in the manner as specified in the guidelines issued by the SEBI. Where income receivables on investments has accrued but has not been received for the period specified in the guidelines issued by the SEBI, provision shall be made by debiting to the revenue account the income so accrued in the manner specified by guidelines issued by the SEBI.

- NAVs are disclosed on daily basis in case of open ended schemes and on weekly basis in case of close-ended schemes.

Mutual funds are required to declare their NAVs and sale-repurchase prices of all schemes updated daily on a regular basis on the AMFI website by 8.00 p.m. and declare NAVs of their close-ended schemes on every Wednesday.

Expense Ratio It is the ratio of expenses incurred by a mutual fund for managing a fund to net assets of the fund. The expense ratio represents the proportion of the fund's assets that go toward the expense of running the fund. It is a measure of the costs associated with operating a fund and these costs are deducted from the assets and thus, lower the return to the investor. Expense ratio includes expenses such as management fees (salaries and bonuses paid to top management and sales personnel), administrative costs (custodian charges, legal and audit fees, marketing and selling expenses, and other miscellaneous expenses), and commission paid to the distributor which is usually paid on a quarterly basis and is generally 0.5 per cent of the asset value. Expense ratio is different from load. Expense ratio is the cost of owning a fund while load is a cost of buying a fund. A load is paid directly by the investor to the fund at the time of buying, while expense ratio is charged as a percentage of net assets and subtracted from the investor's investments every year. The expense ratio is disclosed by a mutual fund house once every six months, *i.e.*, every March and September. SEBI Mutual Fund regulations permit equity funds to charge a maximum of 2.5 per cent and debt funds, a maximum of 2.25 per cent as expense ratio. Expense ratio is higher for actively managed funds and lower for passively managed funds such as index funds. On an average, index funds have an expense ratio of around 1–1.5 per cent which is lower than that of equity funds that have an expense ratio of 1.5–2 per cent. In case of an index fund scheme or exchange traded fund, the total fee charged from an investor, including the investment and advisory expenses, cannot exceed 1.5% of the weekly average net assets.

Entry and Exit Load Mutual funds incur certain expenses such as brokerage, marketing expenses, and communication expenses. These expenses are known as 'load' and are recovered by the fund when it sells the units to investors or repurchases the units from withholders. In other words, load is a sales charge, or commission, assessed by certain mutual funds to cover their selling costs.

Loads can be of two types—front-end-load and back-end-load. Front-end-load, or sale load, is a charge collected at the time when an investor enters into the scheme. Back-end, or repurchase, load is a charge collected when the investor gets out of the scheme. Schemes that do not charge a load are called 'no load' schemes. In other words, if the asset management company (AMC) bears the load during the initial launch of the scheme, then these schemes are known as no-load schemes. However, these no-load schemes can have an exit load when the unitholder gets out of the scheme before a stipulated period mentioned in the initial offer. This is done to prevent short-term investments and redemptions. Some funds may also charge different amount of loads to investors depending upon the time period the investor has

- SEBI abolished entry load for all mutual fund schemes launched on or after August 1, 2009.

stayed with the funds. The longer the investor stays with the fund, less is the amount of exit load charged. This is known as contingent deferred sales charge (CDSL). It is a back-end (exit load) fee imposed by certain funds on shares redeemed with a specific period following their purchase and is usually assessed on a sliding scale.

The SEBI has advised all mutual funds to use a uniform method for calculating sale and repurchase price effective from August 5, 2002, according to which the load shall be charged as a percentage of the NAV. The sale and repurchase price will be calculated using the following formulae: Sale Price = Applicable NAV (1 + sale load, if any). Repurchase Price = Applicable NAV (1 – Exit load, if any).

For investors, entry load increases the cost of investment resulting in a lesser number of units allocated and lower rate of return on investment. The entry load was around 2.25 per cent in most equity schemes. The SEBI has mandated that the asset management companies (AMCs) shall not charge entry as well as exit loads on bonus units and on units allotted on reinvestment of dividend from March 18, 2008.

No entry load shall be levied on direct applications received by the AMCs through Internet, submitted to AMC or collection centres/Investor-service centres provided that the applications are not routed through any distributor/broker/agent on investment in existing schemes with effect from January 4, 2008, and in new schemes launched on/after the same date. There will be no provision of charging initial issue expenses and amortization of the same in respect of all mutual fund close-ended schemes launched thereafter. The schemes shall meet the sales, marketing, and other such expenses from the entry load.

In order to empower the investors in deciding the commission paid to distributors in accordance with the level of service received, to bring about more transparency in payment of commissions and to incentivise long term investment, the SEBI abolished the entry load for all mutual fund schemes on June 30, 2009. The upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor.

Moreover, of the exit load or CDSC charged to the investor, a maximum of 1% of the redemption proceeds shall be maintained in a separate account which can be used by the AMC to pay commissions to the distributor and to take care of other marketing and selling expenses. Any balance shall be credited to the scheme immediately which would go to increase the NAV of the investors who stay invested. The distributors should disclose all the commissions (in the form of trail commission or any other mode) payable to them for the different competing schemes of various mutual funds from amongst which the scheme is being recommended to the investor. These provisions shall be applicable for:

1. Investments in mutual fund schemes (including additional purchases and switch-in to a scheme from other schemes) with effect from August 1, 2009;
2. Redemptions from mutual fund schemes (including switch-out from other schemes) with effect from August 1, 2009;
3. New mutual fund schemes launched on and after August 1, 2009; and
4. Systematic Investment Plans (SIP) registered on or after August 1, 2009.

- Exit load is charged to:
  - discourage investors from exiting a fund within a short span.
  - cover advertising and other expenses of the scheme.

Many funds changed their exit load structure after the entry load was abolished. Many mutual funds hiked their exit load or increased the period of holding. The primary objective of an exit load is to discourage investors from exiting a fund within a short span, as frequent churning (prematurely exiting) increases the costs incurred by the scheme. Exit loads are also charged to cover advertising and other expenses related to managing the scheme or making payment to the distributors. It is a kind of deferred sales charge; the longer an investor holds his units, charges become lower or even nil thus enabling to achieve the true objective of mutual funds—'capital appreciation over the long term'. Liquid funds do not have an exit load but liquid plus schemes may have an exit load as a new norm requires to value money market and debt securities with a maturity of over 91 days to the daily market price from August 1, 2010. This would lead to volatility in returns, resulting in panic redemptions and to avoid this mutual funds may impose exit loads depending on the average maturity.

SEEI vide circular dated May 23, 2008 simplified the formats for Offer Document and Key Information Memorandum of Mutual Funds Scheme. The simplified Scheme Information Document format provides that "Wherever quantitative discounts are involved the following shall be disclosed—The Mutual Fund may charge the exit load within the stipulated limit of 7% and without any discrimination to any specific group of unit holders. However, any change at a later stage shall not affect the existing unit holders adversely".

Assets Under Management (AUM) The Mutual fund manager mobilizes funds by offering a scheme/s which is/are then deployed in various securities/assets. Market value of these assets is known as assets under management. AUM of a scheme is calculated by multiplying the Net Asset Value (NAV) of a scheme by the number of units issued by that scheme. AUM of a mutual fund house is arrived at by adding the AUMs of all schemes offered by it and the sum total of AUMs of all mutual fund houses is AUM of mutual fund industry. A change in market prices/NAV or redemptions leads to a change in AUM.

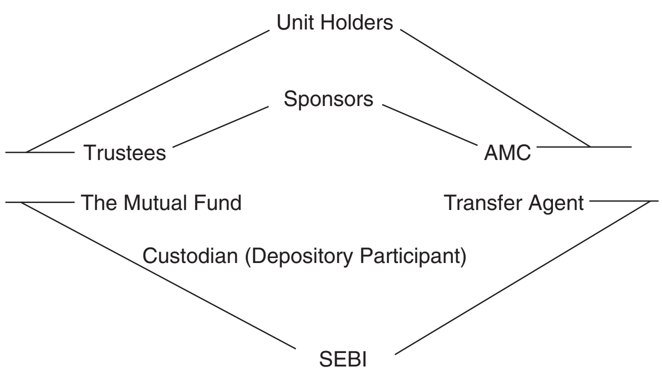
MUTUAL FUND INVESTORS AND ORGANIZATION OF A MUTUAL FUND

Mutual funds in India are open to investment by:

- Residents including
- Resident Indian individuals, including high net worth individuals and the retail or small investors
- Indian companies
- Indian trusts/charitable institutions
- Banks
- Non-banking finance companies
- Insurance companies
- Provident funds
- Non-residents, including Non-resident indians
- Foreign entities, namely, foreign institutional investors (FIIs) registered with the SEBI. Foreign citizens/entities are however not allowed to invest in mutual funds in India.

Figure 15.1 gives an idea of the organization of a mutual fund.

Three key players namely the sponsor, the mutual fund trust, and the asset management company (AMC) are involved in setting up a mutual fund. They are assisted by either independent administrative entities like banks, registrars, transfer agents, and custodians (depository participants).



Source: AMFI.

Figure 15.1 Organization of a Mutual Fund

Sponsor

Sponsor means any person who acting alone or with another body corporate establishes a mutual fund. The sponsor of a fund is akin to the promoter of a company as he gets the fund registered with the SEBI. The SEBI will register the mutual fund if the sponsor fulfills the following criteria:

- The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions. This means that the sponsor should have been doing business in financial services for not less than five years, with positive net worth in all the immediately preceding five years. The net worth of the immediately preceding year should be more than the capital contribution of the sponsor in AMC and the sponsor should show profits after providing depreciation, interest, and tax for three out of the immediately preceding five years.
- The sponsor and any of the directors or principal officers to be employed by the mutual fund, should not have been found guilty of fraud or convicted of an offence involving moral turpitude or guilty of economic offences.

The sponsor forms a trust and appoints a board of trustees. He also appoints an AMC as fund managers. The sponsor, either directly or acting through the trustees, also appoints a custodian to hold the fund assets. The sponsor is required to contribute at least 40 per cent of the minimum net worth of the asset management company.

A mutual fund can be sponsored by a bank, financial institution, or companies whether foreign or Indian or a joint venture between Indian and foreign entities. Out of the 39 mutual funds in India, four are bank sponsored, one by Life Insurance Corporation, sixteen by Indian entities, five by foreign entities,

TABLE 15.1 Assets Under Management for the Quarter Ended June 2017

Sl. No		Name of the Asset Management Company	(₹ in Crores)
A		**BANK SPONSORED**	
	(i)	**Joint Ventures—Predominantly Indian**	
	1	BOI AXA Investment Managers Private Limited	**4,014**
	2	Canara Robeco Asset Management Company Limited	10,753
	3	SBI Funds Management Private Limited	1,68,816
		Total A(i)	**1,83,583**
	(ii)	**Joint Ventures—Predominantly Foreign**	
	1	Baroda Pioneer Asset Management Company Limited	10,764
		Total A (ii)	**10,764**
	(iii)	**Others**	
	1	IDBI Asset Management Ltd.	7,296
	2	Union Asset Management Company Private Limited	3,767
	3	UTI Asset Management Company Ltd.	1,45,340
		Total A (iii)	**1,56,403**
		Total A (i + ii + iii)	**3,50,750**
B		**INSTITUTIONS**	
		Indian	
	1	IIFCL Asset Management Co. Ltd.	1,858
	2	LIC Mutual Fund Asset Management Limited	22,514
		Total B	**24,372**
C		**PRIVATE SECTOR**	
	(i)	**Indian**	
	1	Edelweiss Asset Management Limited	7,272
	2	Escorts Asset Management Limited	258
	3	IL&FS Infra Asset Management Limited	1,046
	4	IIFL Asset Management Ltd.	820
	5	Indiabulls Asset Management Company Ltd.	10,072
	6	JM Financial Asset Management Limited	12,313
	7	Kotak Mahindra Asset Management Company Limited	1,01,197
	8	L&T Investment Management Limited	44,484
	9	Mahindra Asset Management Company Private Limited.	2,105
	10	Motilal Oswal Asset Management Company Limited	10,373
	11	Peerless Funds Management Co. Ltd.	956
	12	PPFAS Asset Management Pvt. Ltd.	760
	13	Quantum Asset Management Company Private Limited	1,066
	14	Sahara Asset Management Company Private Limited	67
	15	Shriram Asset Management Co. Ltd.	42
	16	Sundaram Asset Management Company Limited	32,178
	17	Tata Asset Management Limited	42,148
	18	Taurus Asset Management Company Limited	583
		Total C (i)	**2,67,740**
	(ii)	**Foreign**	
	1	BNP Paribas Asset Management India Private Limited	6,478
	2	Franklin Templeton Asset Management (India) Private Ltd.	90,619

(*Continued*)

TABLE 15.1 (Continued)

Sl. No	Name of the Asset Management Company	(₹ in Crores)
3	Invesco Asset Management (India) Private Limited	24,258
4	Mirae Asset Global Investments (India) Pvt. Ltd.	9,201
	Total C (ii)	**1,30,556**
(III)	**Joint Ventures—Predominantly Indian**	
1	Axis Asset Management Company Ltd.	63,599
2	Birla Sun Life Asset Management Company Limited	2,05,715
3	DSP BlackRock Investment Managers Private Limited	70,991
4	HDFC Asset Management Company Limited	2,53,044
5	ICICI Prudential Asset Mgmt. Company Limited	2,60,225
6	IDFC Asset Management Company Limited	61,361
7	Reliance Nippon Life Asset Management Limited	2,22,964
	Total C (iii)	**11,37,899**
(iv)	**Joint Ventures—Predominantly Foreign**	
1	HSBC Asset Management (India) Private Ltd.	9,316
2	Principal PNB Asset Management Co.Pvt. Ltd.	5,422
	Total C (iv)	**14,738**
(v)	**Joint Ventures—Other**	
1	DHFL Pramerica Asset Managers Private Limited	25,720
	Total C (v)	**25,720**
	Total C (i + ii + iii + iv + v)	**15,76,653**
	Total (A+B+C)	**19,51,775**

and the remaining are joint ventures (Refer Table 15.1). For example, Reliance Mutual Fund (RMF) is sponsored by Reliance Capital Ltd (RCL); HDFC Mutual Fund is a joint venture- sponsored by HDFC and British investment firm Standard Life Investments Limited. All the mutual funds have assets under management of around ₹8 lakh crore.

Mutual Funds as Trusts

A mutual fund in India is constituted in the form of a public trust created under the Indian Trusts Act, 1882. The sponsor forms the trust and registers it with the SEBI. The fund sponsor acts as the settler of the trust, contributing to its initial capital and appoints a trustee to hold the assets of the trust for the benefit of the unit holders, who are the beneficiaries of the trust. The trust deed deals with the establishment of the trust, the authority, and responsibility of the trustees towards the unit holders and the asset management company (AMC). The fund then invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the trust as evidence of their beneficial interest in the fund. Thus, a mutual fund is just a 'pass through' vehicle. Most of the funds in India are managed by the board of trustees, which is an independent body and acts as protector of the unit holders' interests. At least, two-thirds of the trustees shall be independent trustees (who are not associated with an associate, subsidiary, or sponsor in any manner). For example, HDFC Trustee Company Limited, a company incorporated under the Companies Act, 1956, is the Trustee to HDFC Mutual Fund. HDFC Trustee Company Ltd is wholly owned subsidiary of Housing Development Finance Corporation Limited (HDFC). Reliance Mutual Fund (RMF) has been established as a trust under the Indian Trusts Act, 1882, with Reliance Capital Limited (RCL) as the Settlor/Sponsor and Reliance Capital Trustee Co. Limited (RCTCL) as the Trustee, a company incorporated under the Companies Act, 1956.

- A mutual fund is a trust that pools the savings of investors and invests these savings in capital market/money market instruments.

- A trustee company/ board of trustees comprising two-thirds independent trustees is setup by the sponsor.

The trustees shall be accountable for and be the custodian of funds/property of respective scheme. The trustees, on the board of trust of the fund, hold its property for the benefit of the unitholders, which are the investors. The trustees have the power of superintendence and control over the asset management company (AMC). They monitor the performance and compliance of regulations by the mutual fund. The AMC manages the funds by making investments in various types of securities. According to new SEBI regulations, atleast two-thirds of the trustees, on the Board of Trustees must be independent meaning they should not be associated with the sponsors. The new regulations ensure that the trustees will be able to be associated with only one mutual fund and also, bar trustees of one mutual fund to be on the board of trustees or AMC of another mutual fund.

Asset Management Company

- Asset Management Company manges the funds by investing in various securities. It acts like the investment manager of the trust.
- AMCs and corporate trustees have to comply with the provisions of the Companies Act.

The trustees appoint the asset management company (AMC) with the prior approval of the SEBI. The AMC is a company formed and registered under the Companies Act, 1956, to manage the affairs of the mutual fund and operate the schemes of such mutual funds. An Investment Management Agreement is executed between the trustee and the asset management company to manage the mutual fund. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the trust under the supervision and direction of the trustees. The AMC, in the name of the trust, floats and then manages the different investment schemes as per the SEBI regulations and the trust deed. The AMC should be registered with the SEBI.

The AMC of a mutual fund must have a net worth of at least ₹50 crore at all times and this net worth should be in the form of cash. It cannot act as a trustee of any other mutual fund. It is required to disclose the scheme particulars and base of calculation of NAV. It can undertake specific activities such as advisory services and financial consultancy. It must submit quarterly reports to the mutual fund. The trustees are empowered to terminate the appointment of the AMC and may appoint a new AMC with the prior approval of the SEBI and unit holders. At least 50 per cent of the directors of the board of directors of AMC should not be associated with the sponsor or its subsidiaries or the trustees.

Most AMCs in India are private limited companies. The capital of the AMC is contributed by the sponsor and its associates. AMCs are the investment managers of mutual funds. They design new products, provide portfolio management/advisory services, set up offices and distribution centers, appoint distributors, allocate the funds, and report the portfolio performance to trustees and investors.

For example, HDFC Asset Management Company Limited (AMC) acts as an Asset Management Company for the HDFC Mutual Fund. HDFC AMC is a joint venture between housing finance giant HDFC and British investment firm Standard Life Investments Limited. The paid up capital of the AMC is ₹25.161 crore and 60 per cent of this paid-up capital is contributed by Housing Development Finance Corporation Limited and the remaining by Standard Life Investments Limited.

Reliance Mutual Fund schemes are managed by Reliance Capital Asset Management Limited (RCAM), a subsidiary of Reliance Capital Limited, which holds 93.37 per cent of the paid-up capital of RCAM, the balance paid up capital being held by minority shareholders. Reliance Capital Asset Management Ltd. (RCAM) is an unlisted Public Limited Company incorporated under the Companies Act, 1956:

Obligations of an AMC An AMC has to follow a number of obligations. They are as follows:

- The AMC shall take all the reasonable steps and exercise due diligence to ensure that any scheme is not contrary to the trust deed and provisions of investment of funds pertaining to any scheme is not contrary to the provisions of the regulations and trust deed.
- The AMC shall exercise due diligence and care in all its investment decisions. The AMC shall be responsible for the acts of commission or commissions by its employees or the persons whose services have been procured.
- An AMC shall submit to the trustees quarterly reports.
- The trustees at the request of an AMC can terminate the assignments of the AMC.
- An AMC shall not deal in securities through any broker associated with a sponsor or a firm which is an associate of sponsor beyond 5 per cent of the daily gross business of the mutual fund.
- No AMC shall utilise services of the sponsor or any of its associates, employees, or their relatives for the purpose of any securities transaction and distribution and sale of securities, unless disclosure is made to the unit holders and brokerage/commission paid is disclosed in half-yearly accounts of the mutual fund.
- No person, who has been found guilty of any economic offence or involved in violation of securities law, should be appointed as key personnel.
- The AMC shall abide by the code of conduct specified in the fifth schedule.
- The registrars and share transfer agents to be appointed by AMC are to be registered with the SEBI. The SEBI regulations (2001) provide for exercise of due diligence by AMCs in their investment decisions.

For effective implementation of the regulations and also to bring about transparency in the investment decisions, all the AMCs are required to maintain records in support of each investment decision, which would indicate the data, facts, and other opinions leading to an investment decision. While the AMCs can prescribe broad parameters for investments, the basis for taking individual scripwise investment decision in equity and debt securities would have to be recorded. The AMCs are required to report its compliance in their periodical reports to the trustees and the trustees are required to report to the SEBI in their half-yearly reports. Trustees can also check its compliance through independent auditors or internal statutory auditors or through other systems developed by them.

- The AMC has to make a continuous effort to remind the investors through letters to take their unclaimed amounts. In case of schemes to be launched in the future, disclosures on the above provisions are required to be made on the offer documents. Also, the information on amount unclaimed and number of such investors for each scheme is required to be disclosed in the annual reports of mutual funds. The unclaimed redemption and dividend amounts can now be deployed by the mutual funds in call money market or money market instruments and the investors who claim these amounts during a period of three years from the due date shall be paid at the prevailing net asset value. After a period of three years, the amount can be transferred to a pool account and the investors can claim the amount at NAV prevailing at the end of the third year. The income earned on such funds can be used for the purpose of investor education.

- Mutual funds in India are governed by the SEBI (Mutual fund) Regulations, 1996.

General Obligations These obligations are:

- Every AMC, for each scheme, shall keep and maintain proper books of accounts, records, and documents, for each scheme so as to explain its transactions and to disclose at any point of time the financial position of each scheme and in particular give a true and fair view of the state of affairs of the fund and intimate to the board the place where such books of accounts, record, and documents are maintained.
- The financial year for all the schemes shall end as of March 31, of each year. Every mutual fund or the AMC shall prepare, in respect of each financial year, an annual report and annual statement of accounts of the schemes and the fund as specified in eleventh schedule.
- Every mutual fund shall have the annual statement of accounts audited by an auditor who is not in any way associated with the auditor of the AMC.

Procedure in Case of Default On and from the date of the suspension of the certificate or the approval, as the case may be, the mutual fund, trustees, or asset management company shall cease to carry on any activity as a mutual fund, trustee, or AMC during the period of suspension, and shall be subject to the directions of the board with regard to any records, documents, or securities that may be in its custody or control, relating to its activities as mutual fund, trustees, or AMC.

Other Administrative Entities

Custodian A custodian is responsible for safe keeping of cash and securities of the mutual fund. In case of a gold exchange traded fund scheme, the assets of the scheme being gold or gold-related instruments are kept in custody of a bank which is registered as a custodian with the SEBI. The custodian is also involved in clearing and settlement of dematerialized securities transactions on behalf of mutual funds.

Custodian is appointed by the trustee and is independent of the sponsor. No custodian in which the sponsor or its associates hold 50 per cent or more of the voting rights of the share capital of the custodian or where 50 per cent or more of the directors of the custodian represent the interest of the sponsor or its associates shall act as custodian for a mutual fund constituted by the same sponsor or any of its associates or subsidiary company.

The Reliance Capital Trustee Co. Limited—trustee of the Reliance Mutual Fund—has appointed Deutsche Bank, AG as the Custodian of the securities that are bought and sold under the Scheme. A Custody Agreement has been entered between Deutsche Bank and Reliance Capital Trustee Co. Limited.

A custodian provides post-trading and custodial services to the mutual fund, keeps securities and other instruments belonging to the scheme in safe custody, tracks corporate actions and payouts such as rights, bonus, offer for sale, buy back offers, dividends, interest, and redemptions on the securities held by the fund, ensures smooth inflow/outflow of securities and such other instruments as and when necessary, in the best interests of the unitholders, ensures that the benefits due to the holdings of the Mutual Fund are recovered, offer fund accounting and valuation services to mutual funds, and is responsible for loss of or damage to the securities due to negligence on its part on the part of its approved agents.

- A custodian is responsible for safe keeping of cash, securities, gold or gold related instruments or real estate mutual fund instruments. A custodian also participates in the clearing system through approved depository.
- Registrar and Transfer Agent is a vital communication link between the unit holder and mutual fund.

Registrar and Transfer Agents They accept and process investor's applications, handle communications with investors, perform data entry services, despatch account statements, and also perform such other functions as agreed, on an ongoing basis. The Registrar is responsible for carrying out diligently the functions of a Registrar and Transfer Agent and is paid fees for investor services. Reliance Capital Asset Management Limited has appointed M/s. Karvy Computershare Pvt. Limited to act as the Registrar and Transfer Agent to the Schemes of Reliance Mutual Fund. HDFC Mutual Fund has appointed Computer Age Management Services Pvt. Ltd as the Registrar and Transfer Agent.

Role of Intermediaries in the Indian Mutual Fund Industry

Intermediation in the mutual fund industry started with individual agents providing the foundation for growth in the early years. AMCs appoint distributors/agents who sell the mutual fund units to investors on behalf of the mutual fund. Distributors may sell mutual fund units of more than one mutual fund. Now there are a wide variety of intermediaries such as institutional agents, distribution companies, brokers, banks, finance companies, secondary market brokers and post offices who are marketing mutual funds to their existing and potential clients. They make the forms available to clients, explain the schemes and provide administrative and paperwork support to investors, making it easy and convenient for the clients to invest. Investors can also directly purchase mutual fund units from asset management companies (AMCs) including the Unit Trust of India.

Investors of mutual funds can be broadly classified into three categories:

- Those who want product information, advice on financial planning and investment strategies.
- Those who require only a basic level of service and execution support, *i.e.*, delivering and collecting application forms and cheques, and other basic paperwork and post-sale activities.
- Those who prefer to do it all themselves, including choice of investments as well as the process/paperwork related to investments.

To cater to different types of investors, intermediaries offer the following two levels of services:

- **Value added services:** This includes product information and advice on financial planning and investment strategies. The advice encompasses analyzing an investor's financial goals depending upon the segment of investor, assessing his/her resources, determining his/her riskbearing capacity/preference and then using this information to recommend an asset allocation/ specific investment/s that are in tandem with the investor's needs. Investors ay also receive information on taxation, estate planning, and portfolio rebalancing to remain aware about the changes/developments in market conditions and adjust the portfolios from time-to-time according to their needs. In such advisory services, the emphasis is on building an ongoing relationship with the investor/s.
- **Basic services:** This includes providing the basic information on schemes launched to investors, assisting them in filling application forms, submission of application forms alongwith cheques at the respective office/s, delivering redemption proceeds, and answering scheme-related queries investor/s may have. What investors receive here is convenience and access to mutual funds through agents and employees of brokers who visit them and facilitate the paperwork related to investment.

These services are also given through the branches and front office staff of AMCs and intermediaries.

Now, mobile commerce facility is offered by mutual funds for their investors whereby they can purchase, redeem, or switch units of mutual fund schemes using their mobile phones. They can also view their account details, transaction details, and request for their account statements and check the Net Asset Values (NAV) of the schemes of the mutual fund.

The SEBI has facilitated transactions in mutual fund schemes through the Stock Exchange infrastructure. The infrastructure that already exists for the secondary market transactions through the stock exchanges with its reach to over 1,500 towns and cities, through over 200,000 stock exchange terminals can be used for facilitating transactions in mutual fund schemes. Units of mutual fund schemes are permitted to be transacted through registered stock brokers of recognized stock exchanges market. This on-line trading facility on stock exchanges is an order routing system wherein the eventual transaction is executed by the fund house. Both the NSE and the BSE have launched mutual funds trading platform. This will lead to paperless mutual fund transactions leading to a reduction in paper work, high reach, and high security for investors.

Types of Mutual Fund Schemes

The objectives of mutual funds are to provide continuous liquidity and higher yields with high degree of safety to investors. Based on these objectives, different types of mutual fund schemes have evolved.

Box 15.2 Types of Mutual Fund Schemes

Functional	Investment Pattern	Portfolio-objective	Geographical	Other
Open-ended schemes	**Equity Funds**	Income	Domestic	P/E Ratio
Close-ended schemes	Diversified	Growth	Off shore	Exchange Traded Funds – Gold Exchange Traded Funds – Other Exchange Traded Funds Real Estate Mutual Funds
Interval schemes	Value	Balanced		
	Special			
	Sectoral			
	Derivatives Arbitrage			
	Tax Saving-ELSS			
	Index			
	Fund-of-funds			
	Quant			
	Debt Funds			
	Money Marker/Liquid			
	Short-term Bond			
	Long-term Bond			
	Gilt			
	Floating Rate			
	Fixed Maturity Plans			
	Capital Protection Schemes			

Functional Classification of Mutual Funds

Open-ended Schemes In case of open-ended schemes, the mutual fund continuously offers to sell and repurchase its units at NAV or NAV-related prices. Unlike close-ended schemes, open-ended ones do not have to be listed on the stock exchange and can also offer repurchase soon after allotment.

- Open-ended schemes are those schemes where investors can redeem and buy new units all throughout the year as per their convenience at NAV-related prices.

Investors can enter and exit the scheme any time during the life of the fund. Open-ended schemes do not have a fixed corpus. The corpus of fund increases or decreases, depending on the purchase or redemption of units by investors.

There is no fixed redemption period in open-ended schemes, which can be terminated whenever the need arises. The fund offers a redemption price at which the holder can sell units to the fund and exit.

Besides, an investor can enter the fund again by buying units from the fund at its offer price. Such funds announce sale and repurchase prices from time-to-time. UTI's US-64 scheme is an example of such a fund.

The key feature of open-ended funds is liquidity. They increase liquidity of the investors as the units can be continuously bought and sold. The investors can develop their income or saving plan due to free entry and exit frame of funds. Open-ended schemes usually come as a family of schemes which enable the investors to switch over from one scheme to another of same family.

Close-ended Schemes Close-ended schemes have a fixed corpus and a stipulated maturity period ranging between two to five years. Investors can invest in the scheme when it is launched. The scheme remains open for a period not exceeding 45 days. Investors in close-ended schemes can buy units only from the market, once initial subscriptions are over and thereafter the units are listed on the stock exchanges where they can be bought and sold. The fund has no interaction with investors till redemption except for paying dividend/bonus. In order to provide an alternate exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV-related prices. The NAV of close-ended schemes are disclosed generally on weekly basis. If an investor sells units directly to the fund, he cannot enter the fund again, as units bought back by the fund cannot be reissued. Close-ended schemes can be converted into an openended one. The units can be rolled over by the passing of a resolution by a majority of the unit holders.

- Close-ended schemes are open for subscription only for a specified period and have a fixed corpus.

- As close-ended schemes are listed on one or more stock exchanges, they are subject to the regulation of the concerned stock exchange through the listing agreement between the fund and the stock exchange.
- Listing of close-ended schemes along with daily computation of NAV and its publication has been made mandatory.

Interval Scheme Interval scheme combines the features of open-ended and close-ended schemes. They are open for sale or redemption during predetermined intervals at NAV-related prices.

Portfolio Classification

Here, classification is on the basis of nature and types of securities and objective of investment.

Income Funds The aim of income funds is to provide safety of investments and regular income to investors. Such schemes invest predominantly in income-bearing instruments like bonds, debentures, government securities, and commercial paper. The return as well as the risk are lower in income funds as compared to growth funds.

Growth Funds The main objective of growth funds is capital appreciation over the medium- to longterm.

They invest most of the corpus in equity shares with significant growth potential and they offer higher return to investors in the long-term. They assume the risks associated with equity investments.

There is no guarantee or assurance of returns. These schemes are usually close-ended and listed on stock exchanges.

Balanced Funds The aim of balanced scheme is to provide both capital appreciation and regular income. They divide their investment between equity shares and fixed interest-bearing instruments in such a proportion that the portfolio is balanced. The portfolio of such funds usually comprises companies with good profit and dividend track records. Their exposure to risk is moderate and they offer a reasonable rate of return. The NAVs of such funds are likely to be less volatile compared to pure equity funds. An example of balanced fund is HDFC Prudence, an equity-oriented hybrid (balanced) fund, with an asset size of ₹3,200 crore. It is the largest and the most popular scheme in the category of balanced funds.

Others The other mutual funds are load funds, exchange traded funds, price-earnings ratio fund, fund-of-funds, and real estate mutual funds.

Investment Classification

Here, the funds can be classified on the basis of the asset class (types of securities) in which they are invested.

1. **Equity fund:** If funds of a particular scheme are invested in equity shares, then it is as an equity fund. Equity funds are riskier compared to debt funds and they can be further classified on the basis of their investment strategy as diversified, aggressive, growth, value, and sector funds. Examples of equity funds are index funds, diversified funds, arbitrage funds, large-cap funds, small-cap funds, mid-cap funds, sector funds, and equity-linked saving schemes.
2. **Debt fund:** If funds of a particular scheme are invested in debt instruments, then it is a debt fund. Debt funds are characterized as low- risk and high liquidity investments. Debt funds invest in government securities, money market instruments, corporate debt instruments including floating rate bonds and non-convertible debentures, PSU bonds, securitized debt including asset-backed securities, and mortgage-backed securities and bank fixed deposits. Examples of debt funds are liquid/money market funds, income funds, gilt funds, fixed maturity plans, and floating rate funds.
3. **Hybrid fund:** In order to provide the benefits of both equity and debt investment to the investors, some funds invest in both the asset classes and they are known as hybrid funds. Hybrid funds may be further categorized into equity-oriented fund and debt-oriented fund.
   a. Equity-oriented funds are defined as those schemes where the equity holding of the fund in domestic companies is more than 65 per cent.
   b. Debt-oriented funds are those where the investment in debt securities exceeds 65 per cent. Examples of debt-oriented funds are capital protection schemes, monthly income plans, and children's investment funds.
   c. Balanced funds are those where 50 per cent is invested in equity instruments and 50 per cent in debt instruments.

Geographical Classification

Domestic Funds Funds which mobilise resources from a particular geographical locality like a country or region are domestic funds. The market is limited and confined to the boundaries of a nation in which the fund operates. They can invest only in the securities which are issued and traded in the domestic financial markets.

Offshore Funds Offshore funds attract foreign capital for investment in the country of the issuing company. They facilitate cross-border fund flow which leads to an increase in foreign currency and foreign exchange reserves. Such mutual funds can invest in securities of foreign companies. They open domestic capital market to international investors. Many mutual funds in India have launched a number of offshore funds, either independently or jointly with foreign investment management companies. The first offshore fund, The India Fund, was launched by Unit Trust of India in July 1986 in collaboration with the US fund manager, Merril Lynch.

EQUITY FUNDS

Diversified Equity Funds

Equity Funds

- Diversified Equity Funds:
  - Large-cap
  - Mid-cap
  - Small-cap
- Value
- Special
- Sectoral
- Derivatives
- Tax Saving
- Index
- Fund-of-Funds
- Quant

These funds invest in equity shares and hold a diversified equity portfolio. These funds are characterized as high risk high return investments as their returns are linked to the performance of the stock market. But when compared to sectoral funds, they feature a lower risk. Unlike equity linked savings schemes (ELSS), they have no lock-in period. Examples of diversified funds are HDFC Equity, HDFC Top200, HSBC Equity, and Birla SunLife Frontline Equity.

Categories of Diversified Equity Funds

(a) Large-cap Funds These are funds that make investments mainly in the shares of big companies. The investors prefer to make investments in these funds as the portfolio consists of well established companies with high trading volumes and market capitalization of more than ₹1000 crores. Examples of major large- cap funds are Franklin India Blue Chip, HDFC Top 200, Reliance Growth Fund, and Kotak 30.

(b) Mid-cap Funds These funds invest in equity shares of medium sized companies that have a market capitalization between ₹500 crore and ₹1,000 crore and a huge potential to become big. Mid cap funds are volatile as risk of failures especially during the down turn in business cycles can be high. Examples of mid-cap funds are Sundaram BNP Paribas Select Mid Cap Fund, Franklin India Prima Fund, HDFC Capital Builder, Kotak Indian Mid Cap Fund, and HSBC Midcap Equity Fund.

(c) Small-cap Funds These funds invest in equity shares of small companies with a market capitalization of up to ₹500 crore. Some small and upcoming companies have ability to grow faster than the large caps and have the potential of providing high returns. But these companies need to be explored as the information available about them is limited compared to large caps. Examples of small-cap funds are DSPBR Small and Mid Cap Fund and Sundaram BNP Paribas Select Small Cap Fund.

- There are 10 small-cap funds in India with AUM of around ₹3,450 crores.

Value Funds

These funds invest in undervalued stocks-stocks with strong fundamentals but are under performing-either due to a difficult phase or economic downturn. For instance, during 2008, higher raw material cost and slack in demand resulted in underperformance of the auto sector. Consequently, blue-chip auto stocks like Bajaj Auto and Hero Honda underperformed. Value stocks are acquired not only from large-cap segment but also from mid-cap and small-cap segments. Superior returns can be earned from value investing in the long run. Examples of value funds are ICICI Prudential Discovery, Tata Equity PE, Templeton India Growth, and UTI Master Value.

Special Funds

Mutual funds have launched special schemes to cater to the special needs of investors. Examples of special schemes are ICICI Child Care Plan–Gift Plan, Tata Young Citizen's Fund, and UTI Mahila Unit Scheme. Taurus AMC has launched an open-ended diversified equity fund—Taurus Ethical Fund—which invests in stocks that comply with Shariah norms. This fund does not invest in industries not permitted by Shariah such as banks, liquor, and tobacco.

Sectoral Funds

- Arbitrage funds exploit arbitrage opportunities available between the cash and futures market of a particular stock.
- Fixed maturity plans are short-term close-ended schemes investing in short-term debt instruments.

These funds, also known as thematic funds, restrict their investments to a particular segment or sector of the economy such as infrastructure, banking, technology, energy, real estate, power, heath care, FMCG, pharmaceuticals, etc. They are high- risk, high- return investments and they generate high returns if the particular sector in which funds are invested perform well. For example, Reliance Mutual Fund launched Reliance Diversified Power Sector Fund, Reliance Pharma Fund, and Reliance Media Entertainment., Since these funds focus on just one sector of the economy, they limit diversification and the fund manager's ability to earn higher returns by investing in other sectors which are doing well.

All the IPOs in the mutual fund industry during 2004 were for theme funds. Leadership, valuation, and sector-specific funds were the three broad themes that gained popularity in 2004. The leadership category looks at companies which are leaders in various sectors and on a macrolevel, in sectors that could emerge as leaders in the economy. Sundaram India Leadership, HSBC India Opportunities, Kotak Global India, and ICICI Emerging STAR fall under this category.

Derivatives Arbitrage Funds

They are open-ended equity schemes aimed to generate low volatility and better returns by investing in a mix of cash equities, equity derivatives, and debt markets. This fund claims to provide better returns, tax benefits, and greater liquidity. This fund seeks to buy stocks in the cash market and sell the corresponding stock futures to lock-in the price difference between the two, i.e, the arbitrage spread. Benchmark Derivative, JM Equity and Derivative, ICICI Blended Plans A & B, JM Advantage Arbitrage, UTI Spread, Pru ICICI Equity, and Derivative are some examples of derivatives arbitrage funds.

Tax Saving Schemes

- Equity Linked Savings Scheme and Pension schemes offered by mutual funds are tax saving schemes.

Tax-saving schemes are equity-oriented schemes designed on the basis of tax policy with special tax incentives to investors. Mutual funds have introduced a number of tax-saving schemes. These are close-ended schemes and investments are made for ten years, although investors can avail of encashment facilities after three years. These schemes contain various options like income, growth or capital appreciation. Examples of tax saving schemes are equity linked saving scheme and pension scheme.

- Equity-linked savings schemes diversified, tax saving schemes with a lock-in period of three years.

(a) Equity-linked Savings Schemes Equity-linked savings schemes are diversified schemes investing in shares of blue-chip companies. Returns in these schemes are linked to the returns of the stock market. In order to encourage investors to invest in the equity market, the government has given tax concessions through special schemes. Investment in these schemes entitles the investor to claim an income tax rebate, but these schemes carry a lock-in period of three years before the end of which funds cannot be withdrawn. These schemes being growth oriented, invest predominantly in equities. They fall in the high risk and high return category.

New ELSS plans launched by mutual-fund houses will have to be close-ended schemes that have to be wound up 10 years after allotment of units. Investors cannot plan entry into this scheme as the fund houses can announce the repurchase price only a year after the allotment of units and thereafter on half-yearly basis. The schemes could be wound up before completion of the stipulated 10 years if 90 per cent or more of the units are repurchased before completion of 10 years of the plan. Further, the ELSS plans for a minimum of three months. Schemes launched prior to April 1, 2005 have been exempted from this requirement. Examples of ELSS are SBI Magnum Taxgain, HDFC Long term Advantage Fund, HDFC Tax Saver, and Franklin India Taxshield.

(b) Pension Schemes These are balanced schemes which aim to provide regular income to individuals after their retirement. There are two pension schemes offered by Templeton and UTI which were launched in the '90s, but put together these two schemes have only ₹600 crore between them. Pension plans of insurance companies are more popular as these plans cover risk of life also.

From April 1, 2009 any individual will be able to start a New Pension System (NPS) account. The Pension Fund Regulatory and Development Authority (PFRDA) has mandated six mutual fund houses—UTI Retirement Solutions, SBI, ICICI Prudential Life Insurance, Reliance Capital, IDFC AMC, and Kotak Mahindra AMC—to manage pension fund in the NPS. This pension plan will be managed at 0.09 paisa per ₹100 that is cheaper than even liquid mutual funds. Moreover, investors will have a wide choice of selection of investment and tenure as long as 40 years with the benefit of portability, that is they can change fund manager at no cost.

Index Funds An index fund is a mutual fund which invests in securities in the index on which it is based—BSE Sensex or S&P CNX Nifty. It invests only in those shares which comprise the market index and in exactly the same proportion as the companies/weightage in the index so that the value of such index funds varies with the market index. An index fund follows a passive investment strategy as no effort is made by the fund manager to identify stocks for investment/disinvestment. The fund manager has to merely track the index on which it is based. His portfolio will need an adjustment in case there is a revision in the underlying index. In other words, the fund manager has to buy stocks which are added to the index and sell stocks which are deleted from the index.

- Index funds replicate the portfolio of a particular index such as the BSE Sensex or the S&P CNX Nifty.

Internationally, index funds are very popular. Around one-third of professionally run portfolios in the US are index funds. Empirical evidence points out that active fund managers have not been able to perform well. Only 20 to 25 per cent of actively managed equity mutual funds out-perform benchmark indices in the long-term. These active fund managers park 80 per cent of their money in an index and do active management on the remaining 20 per cent. Moreover, risk averse investors like provident funds and pension funds prefer investment in passively managed funds like index funds. Tracking error can occur in case of index funds. Tracking error is the error between index returns and index fund returns. In other words, there is a deviation of returns from an index fund as compared to the returns on the index. Tracking error is the variance between the daily returns of the underlying index and the NAV of the scheme over a given period. Tracking error is a good measure to compare performance among index funds. Lower the tracking error, better the index fund. Tracking error of various index funds can be calculated by comparing their daily returns with those of its benchmark index. Funds like Franklin India Index, Principal Index, and Prudential ICICI Index consider Nifty TRI as its benchmark, while funds like UTI Master Index and Pru ICICI SPICE track the Sensex TRI.

- Index fund scheme means a mutual fund scheme that invests in securities in the same proportion as an index of securities.

It is a result of transaction costs for buying and selling of stocks and payment of asset management fees.

But an index fund gains over the index owing to stock lending and index arbitrage.

Index funds mirror the performance of their benchmark index. Higher tracking errors can be attributed to factors such as higher expenses of the scheme (higher expense ratio) and large-scale fluctuations/redemptions in the fund's assets under management (AUM).

Fund-of-Funds

A Fund-of-Funds (FOF) scheme invests in a combination of equity and debt mutual fund schemes available in the market. The fund manager changes the percentage of equity and debt allocation based on the market view.

Fund-of-funds invests in other mutual funds and offers a return to investors. Internationally, fund-of-funds do not limit their exposure to other mutual funds. They are more like hedge funds and put money in other fund classes such as private equity funds and distressed assets funds. This enables the investors in FOFs to obtain diversity in risk allocation. This strategy provides the fund manager more flexibility in allocating the investible corpus.

- A Fund-of-funds scheme invests in schemes of the same mutual fund of other mutual funds.

The flip side is that there may be a double layer of fees charged to the end investors. Investors pay the expense fees to the fund manager responsible for the FOF. In addition, they could be required to bear the charges incurred by the fund manager in buying into various MF schemes. Also, it is possible that the fund manager may be buying the same stock through various schemes.

Kotak Mutual Fund has an FOF that invests in schemes of other fund houses. The other mutual funds offering the scheme are Standard Chartered Mutual Fund and Prudential ICICI Mutual Fund. The assets under management (AUM) of FOF schemes is quite low. The factors restraining the growth of FOF are:

- Dividend distribution tax is levied on FOF and this tax rate applicable to individuals is 14 per cent.
- The long-term capital gains tax of 10 per cent without indexation and 20 per cent with indexation is applicable to FOF. In equity mutual funds, the short-term gains tax is 10 per cent and long-term gains tax is nil. Hence, taxes are a major deterrent to the growth of FOFs. All investments in fund-of-funds are treated as debt investments and are taxed like debt funds. Investment in equity funds is exempt from long-term capital gains while debt funds are subject to the same at 10 per cent. Investment in a fund-of-funds attracts a long-term tax of 10 per cent. Fund-of-funds have to be actively managed by fund managers. But it is difficult as very few asset classes are available to invest in and there is lack of information regarding the composition of corporate and retail investment.
- Most fund houses choose their own schemes to invest in an FOF schemes which limits the advantage of diversification an investor is looking for.

Quant Funds

The word 'Quant' is a short form of the term 'Quantitative'. These funds use a quantitative approach to invest in stock markets based on a computer-generated mathematical model. These mathematical models are developed by the mutual fund manager by taking into consideration various parameters such as valuations, earning sentiments, price, momentum, and share holders' value. A quant fund is positioned between two kinds of equity funds, actively managed equity funds and passively managed index funds. Examples of Quant Funds are Lotus Agile Fund and Reliance Quant Plus Fund.

DEBT FUNDS

- Most corporate houses park short-term cash in money market and liquid funds.

Money Market Mutual Funds/Liquid Funds They specialize in investing in short-term money market instruments like treasury bills, CBLO, commercial paper, certificate of deposit, and other money market instruments. They do not carry either interest rate risk or entry or exit loads. The objective of such funds is high liquidity with low rate of return. There is lot of portfolio churning (high portfolio turnover) in liquid funds as the investments are of a very short term nature ranging from daily to monthly. Corporates invest in these funds to park their short-term surplus funds. Examples of money market funds are Templeton India Money Market Account and UTI MMF. There are two types of schemes: Liquid schemes and Liquid Plus schemes. Both invest in short-term debt securities but the difference between the two schemes is that liquid plus schemes invest in debt securities over 91 days maturity while liquid funds invest in money market instruments of maturity below 91 days.

- Liquid fund schemes and plans shall make investment in purchase debt and money market securities with maturity of upto 91 days only.

Short-term Bond Funds These are funds that seek to provide a high degree of liquidity, along with generation of reasonable returns, by investing in a portfolio consisting of short-term debt and money market instruments. Short-term bond funds are most often primarily made up of corporate bonds. During periods of low interest rates, short-term bond funds do not yield higher returns as it is cheaper for companies to raise funds from banks than to raise funds from the corporate debt market.

It is a fund positioned between a liquid and a short-term debt product. The average maturity of the portfolio would be longer than a typical Liquid scheme but shorter than a typical debt scheme. Correspondingly, the risk-return magnitude would also be higher than liquid but lower than debt scheme. Examples of short-term bond funds are HSBC Ultra Short Term Bond Fund and Kotak Bond Short Term.

Long-term Bond Funds These funds invest in long-term government dated securities and corporate bonds. The market price of the underlying securities—government securities, bonds, debentures—determines the net asset value (NAV) of these funds. These securities carry high interest rate risk There is an inverse relationship between the interest rates and NAV of bond funds. With a change (increase/decrease) in the interest rates, the market price of bonds fluctuates (decreases/increase) leading to a change (fall/rise) in the NAV of bond funds. An example of long-term bond funds is Kotak Bond.

- Gilt funds invest exclusively in government securities.
- Schemes that charge a load *i.e.*, a percentage of NAV for entry or exit are known as Load Fund.

Gilt Funds Mutual funds which invest exclusively in government securities, both central and state government, are called gilt funds. Gilt funds are safe as they do not carry credit or default risk. With a view to creating a wider investor base for government securities, the RBI encouraged setting up of gilt funds. These funds are provided liquidity support by the RBI.

Floating Rate Funds Floating rate funds are non-traditional funds which invest in floating rate instruments. A floating rate instrument is one where the coupon rate is reset periodically to reflect the current interest rates. The coupon rate is linked to a benchmark rate which may be the overnight call money rate or treasury bill rate. In India, a variety of benchmark rates such as MIBOR (Mumbai Interbank Offer Rate), INBMK (Routers India Gilts Benchmark), INCPBMK (Reuters India Commercial Paper Reference Rate), yields on 91-day and 364-day treasury bill auctions are used by market players. The most popular among these is the MIBOR.

- Floating rate funds invest in floating rate instruments.

Floating rate instruments serve as an effective hedge against rising interest rates. With interest rates bottoming out and rise in inflation, floating rate funds are gaining popularity.

A higher number of companies issued floating rate bonds in 2004. The benchmark five year AAA corporate bond yield rose resulting in an increase in cost of borrowing. Hence, most of the companies raised funds via FRBs to save on coupon payments. FRBs allow issuers to borrow on a long-term (3 to 5 year tenors) basis based on a one-year benchmark such as government security yield or the call money rate—MIBOR. Moreover, demand for FRBs stemmed from mutual funds. The floating rate schemes of mutual funds gained popularity which led to companies increasing by issuing floating rate bonds.

Floating rate bonds are attractive as they can be swapped into a fixed rate through the overnight indexed swap (OIS) market. The overall cost of borrowing after paying the swap cost works out to be cheaper than a fixed rate bond. floating rate funds and liquid funds perform better when interest rates inch up There are 38 floating rate fund schemes available to investors in India. This product is attractive to investors who are seeking protection from rising inflation and potential interest rate rise.

Templeton Floating Rate Fund is the largest floating rate fund in the Indian mutual fund industry. The fund was launched in 2002 with two plans—the long-term plan and the short-term plan. The asset allocation of the fund is a maximum of 35 per cent in fixed rate instruments and a minimum of 65 per cent in floating rate instruments.

Fixed Maturity Plans They are debt-oriented funds, which invest in fixed income securities like bonds, government securities and money market instruments. Being close-ended income schemes, they have a fixed maturity period ranging from 15 days to one year. There are three-months, half-year, one-year durations fixed maturity plans offered by mutual fund houses. As these bonds are held-to-maturity, these funds are relatively less susceptible to interest rate risk. Fixed maturity plans (FMPs) lock-in the yield till maturity to curb the interest rate risk. They are popular as they provid higher returns in the shorter term. In an increasing interest rate scenario, fund houses invest in bonds of shorter duration which fetch good yields for investors. Also, investing in FMPs during the last week of March gives rise to the tax planning mechanism of double indexation. Let us understand this with the help of an illustration.

- Fixed maturity plans are short-term close-ended schemes investing in short-term debt instruments.

Suppose Mr A's income is more than ₹10 lakh p.a. He wants to invest on March 25, 2010 for one year an amount of ₹5 lacs . He has two options: to invest this amount in a fixed deposit which will earn him an interest rate of 9 per cent per annum or to invest this amount in a fixed maturity plan which will yield him a return of 8.9 per cent for 375 days. Suppose the official inflation rate on March 31, 2010 is 5 per cent. In which option should Mr A invest his money?

The interest income on fixed deposit will be fully taxable in the hands of the investor. The tax rate applicable to Mr A is 33 per cent. Hence, the tax liability on interest income of ₹45,000 (₹5,00,000 × 9%) is ₹14,850/-. Thus, the net interest income after tax on fixed deposit is ₹30,150/-. Now, if he invests in FMP he will earn a yield of ₹44,500 (₹5,00,000 × 8.9%). As he is investing during the last week of March, he will get benefit of capital gain double indexation (as the investment is across two financial years) which is 5 per cent + 5 per cent = 10 per cent which raises the basic cost to ₹5,50,000, thus exempting him from tax on capital gain. Thus, the net income after tax on investment in FMP is ₹44,500/-.

Capital Protection Schemes Investment in equity markets is risky as there is a possibility of losing investment. Risk averse investors avoid investing in stocks and prefer low-return assured schemes such as NSC, Post office monthly income schemes, provident fund, bank deposits, etc. In order to attract these risk-averse investors to mutual funds and increase the total size of the market of mutual funds, SEBI gave approval to fund houses to launch Capital Protection Schemes (CPS). These schemes aim at protecting the initial capital investment of the investor and do not guarantee any assured returns. Few years ago mutual funds used to offer assured return schemes which assured a specific (fixed) return to the investors irrespective of the performance of the scheme. These schemes were banned in 2004.

- Capital protection schemes aim at protecting the initial capital investment of the investor.
- These schemes are close-ended and rated by a credit-rating agency.

According to SEBI guidelines, in case of capital protection oriented scheme, the mutual funds shall disclose in the offer document, Key Information Memorandum (KIM) as well as in the advertisements that the scheme offered is 'oriented towards protection of capital' and 'not with guaranteed returns'. It should also be indicated that the orientation towards protection of the capital originates from the portfolio structure of the scheme and not from any bank guarantee, insurance cover etc. The proposed portfolio structure should be rated on a quarterly basis by a credit rating and continuously monitored by the trustees from the perspective of assessing the degree of certainty for achieving the objective of capital protection. Further, it should also be ensured that the debt component of the portfolio structure has the highest investment grade rating.

Capital protection scheme is close-ended and rated by a credit rating agency. Under this scheme, a large proportion of the corpus is invested in highly-rated debt securities to ensure capital protection and small proportion of the corpus is invested in equities to gain from capital appreciation to provide a return higher than the traditional low-return assured schemes of the government and banks.

This scheme is of advantage to both the risk-averse investors and fund managers. The investors capital is protected and they can access the capital market without increasing their risk. Being closeended schemes, the fund managers can effectively manage the funds but the investors funds are blocked for a particular period.

Franklin Templeton Capital Protection Oriented Fund, Reliance Capital Shield Fund, and Sundaram BNP Paribas Savings Plus are some examples of Capital Protection Schemes.

OTHER FUNDS

- P/E ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market.
- Exchange traded funds are index funds listed and traded on the stock exchange.

P/E Ratio Fund P/E ratio fund is another mutual fund variant that is offered by Pioneer ITI Mutual Fund. The P/E (price–earnings) ratio is the ratio of the price of the stock of a company to its earnings per share (EPS). The P/E ratio of the index is the weighted average price–earnings ratio of all its constituent stocks.

The P/E ratio fund invests in equities and debt instruments wherein the proportion of the investment is determined by the ongoing price-earnings multiple of the market. Broadly, around 90 per cent of the investible funds will be invested in equity if the Nifty Index P/E ratio is 12 or below. If this ratio exceeds 28, the investment will be in debt/money markets. Between the two ends of 12 and 28 P/E ratio of the Nifty, the fund will allocate varying proportions of its investible funds to equity and debt. The objective of this scheme is to provide superior risk-adjusted returns through a balanced portfolio of equity and debt instruments.

- Benchmark Mutual Fund, ICICI Prudential Mutual Fund, Kotak Mahindra Mutual Fund, Quantum Mutual Fund, Reliance Mutual Fund and UTI Mutual Fund have launched open ended exchange traded funds.

Exchange Traded Funds Exchange traded funds (ETFs) are a hybrid of open-ended mutual funds and listed individual stocks. They are index funds listed on stock exchanges and trade like individual stocks on the stock exchange. However, trading at the stock exchanges does not affect their portfolio. ETFs do not sell their shares directly to investors for cash. The shares are offered to investors over the stock exchange. In case of ETFs, the AMC issues units to 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.

ETFs are basically passively managed funds that track a particular index such as S&P CNX Nifty. They are passive index funds and due to passive fund management these funds charge lesser fees as compared to other funds Since they are open-ended and listed on stock exchanges, it is possible to buy and sell them throughout the day and their price is determined by the demand–supply forces in the market. In practice, they trade in a small range around the value of the assets (NAV) held by them.

ETFs are the innovation of the last few years, a mix between mutual funds and investment trusts. As with mutual funds, new units can be created at any time, so in theory there is no maximum size the fund can reach. This also means that the issuer can keep the price linked to the price of asset, by issuing or redeeming shares if it gets out of line. But, as with investment trusts, they are traded continuously, so you can buy and sell them much like shares. Unlike any other open-ended scheme, where the NAV of the scheme is declared at the end of the day and the units can be bought and sold through the fund house only, ETF units are traded on stock exchanges and can be bought and sold through these exchanges. The rate or price at which the ETF unit is traded on the exchange is very close to the real NAV of the scheme. They can be bought or sold at the prevailing prices through any broker throughout the country. Thus, ETF prices will vary for each investor as the prices vary throughout the day. Moreover, as ETFs are traded on a stock exchange, investors need to open a demat account.

Now, asset classes such as indices, gold, and silver are used to create ETFs. In India, there are ETFs on two asset classes—indices (Nifty, Sensex, and Bankex) and gold.

ETFs offer several distinct advantages.

Advantages of ETFs

- Allows intra-day trading.
- Simple to understand.
- Used to arbitrate between index futures and spot index.
- Provides benefits of diversified index funds.
- Less costly than index funds.
- Beneficial for financial institutions also.

- ETFs bring the trading and real time pricing advantages of individual stocks to mutual funds. The ability to trade intra-day at prices that are usually close to the actual intra-day NAV of the scheme makes it almost real-time trading. ETFs can be bought and sold throughout the trading day, allowing for intra-day trading—which is rare with mutual funds.
- ETFs are simpler to understand and hence they can attract small investors who are deterred to trade in index futures due to requirement of minimum contract size. Small investors can buy minimum one unit of ETF, can place limit orders and trade intra-day. This, in turn, would increase liquidity of the cash market.
- ETFs can be used to arbitrate effectively between index futures and spot index. The presence of market makers can create or redeem units directly with the funds for exchange of defined basket of underlying securities. Hence, any difference in the NAV and the price on the exchange is used as an arbitrage opportunity by the market maker.
- ETFs provide the benefits of diversified index funds. The investor can benefit from the flexibility of stocks as well as the diversification.
- ETFs being passively managed, have a somewhat higher NAV against an index fund of the same portfolio. The operating expenses of ETFs are lower than even those of similar index funds as they do not have to service investors who deal in shares through stock exchanges.
- ETFs can be beneficial for financial institutions also. Financial institutions can use ETFs for utilizing idle cash, managing redemptions, modifying sector allocations, and hedging market exposure.

Working of ETFs

1. An AMC appoints authorized participants (APs) who deposit all the shares that comprise the index (or the gold in case of Gold ETF) with the AMC.
2. The shares or gold deposited with the AMC is known as 'Portfolio Deposit' which is then deposited with a custodian for safe-keeping. The custodian keeps record of all the shares/gold that has been deposited/ withdrawn under the ETF.
3. The AMC then allots 'creation units' to the authorized participants. Creation units are bundled ETF units which are then split into small units for selling to retail investors. Each Creation Unit comprises of a pre-defined number of ETF Units (say 100, 500, 1,000, 10,000, or any other number).
4. If there is more demand, these authorized participants will increase their portfolio deposit (deposit more shares/gold) with the AMC and get more creation units to satisfy the demand. Or if there is more redemption, then they give back these creation units to the AMC, take back their shares/gold, sell them in the market, and pay the investor.

The first exchange traded fund—Standard and Poor's Depository Receipt (SPDR—also called Spider)—was launched in the US in 1993. ETFs have grown rapidly with around USD 100 billion in assets as on December 2001. Today, about 60 per cent of trading value on the American Stock Exchange (AMEX) is from ETFs. ETFs were launched in Europe and Asia in 2001. Currently, more than 280 ETFs are available in US, Europe, Singapore, Hongkong, Japan, and other countries. Among the popular ones are SPD ₹ (Spiders) based on the S&P 500 Index, QQQs (cubes) based on the Nasdaq-100 Index, i SHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index. The ETF structure has seen over USD 336 billion pouring into more than 390 ETFs. It has become the fastest growing fund structure.

The first ETF to be introduced in India is Nifty Benchmark Exchange-Traded Scheme (Nifty BeES). It is an open-ended ETF, launched towards the end of 2001 by Benchmark Mutual Funds. The fund is listed in the capital market segment of the NSE and trades the S&P CNX Nifty Index. The Benchmark Asset Management Company has become the first company in Asia (excluding Japan) to introduce ETF. Each Nifty BeES unit is 1/10th of the S&P CNX Nifty Index value. Nifty BeES units are traded and settled in dematerialized form like any other share in the rolling settlement. It charges a management fee of 0.35 per cent and the total expense ratio is 0.80 per cent p.a., which is the lowest in India. It has a tracking error of 0.12 per cent (annualized), which is again the lowest in India for any index fund. Junior BeES was launched by Benchmark Mutual Fund on March 6, 2003 and trades on the capital market segment of the NSE. Each Junior BeES unit is 1/10th of the CNX Nifty Junior Index value. Benchmark Mutual Fund now offers six ETF products: Banking BeES, Benchmark Derivative Fund, Benchmark Split Capital Fund (A and B), Liquid Benchmark ETS, Nifty Benchmark ETS (BeES), and Nifty Junior BeES. The Liquid BeES fund was launched in July 2003 and tracks the Crisil Liquid Benchmark. The banking BeES fund tracks the CNX Bank Index, which comprises 12 key banking stocks. Each unit is priced at 1/10th of the CNX Bank Index. The Benchmark Derivative fund was launched in December 2004 and the Split Capital fund was launched in July 2005. Benchmark Asset Management handles four out of five ETFs currently available in the market. Benchmark AMC has also launched an exchange-traded index fund—Shariah BeES—that invests insecurities which are constituent of S&P CNX Nifty Shariah index in the same proportion as in the index. A Shariah compliant fund is one which does not invest in companies engaged in the business of liquor, tobacco, and banking.

SENSEX Prudential ICICI Exchange Traded Fund (SPICE) is the first exchange traded fund (ETF) on SENSEX launched by Prudential ICICI Mutual Fund. One unique feature of SPICE is that it can be bought and sold like any other equity share on the BSE trading terminal (BOLT) through a stockbroker. The price of one SPIcE unit will be equal to approximately 1/100th of SENSEX value. For example, if the current SENSEX is at 17,500, one SPIcE unit will trade at around ₹175. The minimum lot size is one unit of SPICE and a retail investor can buy one SPICE unit for ₹175 and hold it in his demat account just like any other security. UTI launched UTI Sunder Fund which tracks the S&P CNX Nifty.

Gold Exchange Traded Funds In January 2006, SEBI permitted introduction of Gold Exchange Traded Fund (GETF) schemes by mutual funds. Gold Exchange Traded Fund schemes are permitted to invest primarily in (a) Gold (b) Gold related instruments—Regulation 2 (mc) stipulates that gold related instruments are such instruments having gold as underlying, as may be specified by SEBI from time to time.

Gold Exchange Traded Fund

- A listed security backed by allocated gold held in a custody of a bank on behalf of investors.

Since physical gold and other permitted instruments linked to gold are denominated in gold tonnage, it will be valued based on the market price of gold in the domestic market and will be marked to market on a daily basis. The market price of gold in the domestic market on any business deal would be arrived at as under:

- Allows investors to participate in the gold bullion market without taking physical delivery of gold.
- Gold BeES–India's first GETF launched by Benchmark Asset Management Company in February 2007.
- There are seven open ended Gold ETF schemes:
  - Gold Benchmark Exchange Traded scheme (Gold BeES)
  - Kotak Gold ETF
  - Quantum Gold ETF
  - Reliance Gold ETF
  - Religare Gold ETF
  - SBI Gold ETF
  - UTI Gold ETF

Domestic price of gold = (London Bullion Market Association AM fixing in US \$/ounce × conversion factor for converting ounce into kg for 0.995 fineness × rate for US \$ into INR) + custom duty for import of gold + sales tax/octroi and other levies applicable.

NAV of units under the scheme shall be calculated as shown below:

NAV = Market or Fair Value of Scheme's Investments + Current Assets – Current Liabilities and Provision / Number of Units outstanding under scheme on the valuation date

As there are no indices catering to the gold sector/securities linked to Gold, GETF shall be benchmarked against the price of gold.

Globally, the first GETF—Gold BeES was mooted by Benchmark Mutual Fund during May 2002.

GETFs have been successfully launched in countries like Australia, the UK, the US, and South Africa and have total assets under management (AUM) of over \$2.7 billion.

In India, investment in gold is a preferred avenue and asset allocation in gold is around 10 per cent. Hence, GETFs should be aimed at gold investors who can diversify the portfolio risk and enhance their wealth.

Investment in GETFs is beneficial to investors in many ways.

1. They not only provide ease of trade to investors, but also enable them to buy gold at near-market price.
2. Units can be resold anytime on the stock exchange at the trading price on the date of sale. Resale is not subject to tax deducted at source.
3. Holding gold in demat form does not attract wealth tax and the benefit of long-term gains accrues at the end of one year. Thus, the tax liability on the gains arising from sale of the units is 20 per cent after one year.
4. No storage or insurance costs have to be borne by investors.
5. GETFs are a good hedge against stock market volatility and depreciation of the dollar.

Thus, GETFs are one of the most cost-effective ways to acquire gold. But the investors have to bear brokerage charges at the time of purchase of units from the exchange, which can range from 0.10–1 per cent. Fund houses also charge an expense ratio of 1 per cent per annum on account of administrative and custodian expenses. Moreover, investors cannot exchange GETF units for physical gold or jewellery.

Real Estate Mutual Funds

- Invest in real estate.
- Close-ended fund with units listed on the stock exchange.
- Allow investors participate in the booming real estate market.

Real Estate Mutual Funds Real Estate Mutual Funds (REMFs) mobilize money from individuals and institutions and deploy them in real estate. The real estate industry in India is one of the fastest growing sectors on account of liberalised (100 per cent) FDI regime, booming economy and easy availability of retail loans at attractive rates from banks and financial institutions leading to a bull rally in real estate prices. These funds allow retail investors a chance to participate in the booming real estate market and diversify their investment portfolio. Besides, because of lack of transparency and hassles involved in direct investment in real estate, REMFs provide a sense of security to small investor and ease of transactions.

REMFs also benefit developers of properties as it provides a long-term alternative to bank finance or overseas borrowing. Moreover, participation of REMFs in property development projects can serve to improve corporate governance of real estate companies.

According to the SEBI guidelines,

1. REMFs can invest directly in real estate properties within India, in mortgage-backed (housing lease) securities, in equity shares/bonds/debentures of listed/unlisted companies which deal in properties and also undertake property development.
2. The structure of REMFs will be close-ended initially.
3. The units of REMFs shall be listed on the stock exchanges and NAVs of such schemes should be declared on a daily basis.
4. REMFs should appoint a registered custodian who could safe-keep the titles of the real estate properties held by them.
5. A real estate mutual fund scheme shall not undertake lending or housing finance activities.
6. The asset management company of a mutual fund having real estate mutual fund schemes shall appoint suitable number of qualified key personnel with relevant experience, before undertaking investment management of real estate assets of a real estate mutual fund scheme.
7. SEBI-registered real estate mutual funds will be given a tax pass-through status if they invest the money raised from investors in shares of real estate companies. So will be the case for all mutual funds investing in shares of realty companies.

Definition of Real Estate Asset A 'real estate asset' means an identifiable immovable property:

1. which is located within India in such city as may be specified by the Board from time to time or in a special economic zone within the meaning of clause (za) of Section 2 of the Special Economic Zones Act, 2005 (28 of 2005);
2. on which construction is complete and which is usable;
3. which is evidenced by valid title documents;
4. which is legally transferable;
5. which is free from all encumbrances;
6. which is not subject matter of any litigation; but does not include
   a. a project under construction; or
   b. a vacant land; or
   c. a deserted property; or
   d. a land specified for agricultural use; or
   e. a property which is reserved or attached by any Government or other authority or pursuant to orders of a court of law or the acquisition of which is otherwise prohibited under any law for the time being in force;

Eligibility Criteria A Certificate of registration may be granted under Regulation 9 to an applicant proposing to launch only real estate mutual fund schemes if he has been carrying on business in real estate for a period of not less than five years. An existing mutual fund may launch a real estate mutual fund scheme if it has an adequate number of key personnel and directors having adequate experience in real estate.

Permissible Investments

1. Every real estate mutual fund scheme shall invest at least 35 per cent of the net assets of the scheme directly in real estate assets.
2. Subject to sub-regulation (1), every real estate mutual fund scheme shall invest:
   a. at least 75 per cent of the net assets of the scheme in (i) real estate assets; (ii) mortgage backed securities (but not directly in mortgages); (iii) equity shares or debentures of companies engaged in dealing in real estate assets or in undertaking real estate development projects, whether listed on a recognized stock exchange in India or not;
   b. the balance in other securities;
3. Unless otherwise disclosed in the offer document, no mutual fund shall, under all its real estate mutual fund schemes, invest more than 30 per cent of its net assets in a single city.
4. No mutual fund shall, under all its real estate mutual fund schemes, invest more than 15 per cent of its net assets in the real estate assets of any single real estate project. A 'single real estate project' means a project by a builder in a single location within a city.
5. No mutual fund shall, under all its real estate mutual fund schemes, invest more than 25 per cent of the total issued capital of any unlisted company.
6. No mutual fund shall invest more than 15 per cent of the net assets of any of its real estate mutual fund schemes in the equity shares or debentures of any unlisted company.
7. No real estate mutual fund scheme shall invest in any:
   a. unlisted security of the sponsor or its associate or group company;
   b. listed security issued by way of preferential allotment by the sponsor or its associate or group company;
   c. listed security of the sponsor or its associate or group company, in excess of 25 per cent of the net assets of the scheme.
8. No mutual fund shall transfer real estate assets amongst its schemes.
9. No mutual fund shall invest in any real estate asset which was owned by the sponsor or the asset management company or any of its associates during the period of last five years or in which the sponsor or the asset management company or any of its associates hold tenancy or lease rights.

Valuation of Real Estates Assets and Declaration of Net Asset Value

1. The real estate assets held by a real estate mutual fund scheme shall be valued at:
   a. cost price on the date of acquisition; and
   b. fair price on every 19^{th} day from the day of its purchase in accordance with the norms specified in Schedule IXB.

2. The asset management company, its directors, the trustees, and the real estate valuer shall ensure that the valuation of assets held by a real estate mutual fund scheme are done in good faith, in accordance with the norms specified in Schedule IX B and that the accounts of the scheme are prepared in accordance with accounting principles specified in Schedule XI.
3. The net asset value of every real estate mutual fund scheme shall be calculated and declared at the close of each business day on the basis of the most current valuation of the real estate assets held by the scheme and accrued income thereon, if any.

Usage of Real Estate Assets of a Real Estate Mutual Fund Scheme

1. The asset management company may let out or lease out the real estate assets held by the real estate mutual fund scheme if the term of such lease or letting does not extend beyond the period of maturity of the scheme.
2. Where real estate assets are let out or leased out, the asset management company shall diligently collect the rents or other income in a timely manner.
3. Real estate assets held by a real estate mutual fund scheme may be let out to the sponsor, asset management company or any of their associates, at market price or otherwise on commercial terms provided that not more than 25 per cent of the total rental income of the scheme shall be derived from assets so let out. In the US, wealthy promoters set up Real Estate Investment Trusts (REITs) in 1960 to make investments in large income producing real estates. The shares of many REITs are traded on New York Stock Exchange on the basis of yield. There are over 190 REITs registered with Securities Exchange Commission (SEC) and having total assets exceeding USD 500 billion. These funds have given excellent risk-adjusted returns to the unitholders.

Real Estate Investment Trusts (REITs) REITs are classified as equity, mortgage, or hybrids. Equity REITs own and operate income producing real estate. Mortgage REITs lend money directly to real estate owners and operators or extend credit directly through the acquisition of loans or mortgage-backed securities. Hybrids own properties as well as lend to real estate owners and operators.

REITs pool in investors' money and invest the fund generated in commercial and residential property. An investor, therefore, becomes a 'unitholder' in the REIT. In contrast to directly investing by purchasing property that, otherwise, is expensive to buy, an owner of one REIT unit buys a 'one-unit portion' of a managed pool of property. This pool of property then generates income through renting, leasing, and sales, and distributes the said income directly to the REIT-holder on a regular basis in the form of dividends. REITs would provide an opportunity for small investors to access high yields as well as liquidity at small units of investment. Among other things, REITs invest in residential and commercial property such as shopping malls, office buildings, apartments, warehouses, and hotels. Hence, investment in REIT would make the investor portfolio a diversified one and also increase the stability of income sources. The introduction of REITs in India would provide a further boost to the real estate industry. This would result in increased rental housing generation and also raise cheaper funds for this sector.

- REITs are permitted to invest only directly in real estate mainly in commercial property. They pay the rent collected from properties to shareholders as dividend.

REITs are different from REMFs. Real estate mutual funds (REMFs) are permitted to invest both in real estate directly as well as in securities, including mortgage-backed securities and shares of companies owning/developing real estate. As opposed to that, under the draft regulations, REITs are permitted to invest only directly in real estate. Moreover, REMFs can take development risk and trade in securities, hence have a potential for higher returns, albeit with a higher risk, while REITs would generally invest in stabilized income-yielding assets with lower returns and commensurate risk. Thus, REMFs are like balanced mutual funds, whereas REITs are like pure debt funds.

The SEBI issued draft regulations in January 2008 for the functioning of real estate investment trusts (REITs) in India.

1. The REIT should be in the form of a trust created under the Indian Trusts Act. Trustees should either be a scheduled bank, public financial institution, insurance company, or a body corporate.
2. The scheme should be launched by a trust and managed by a real estate investment management company. Both the trust and real estate investment management company should be registered with the SEBI.
3. Only close-ended schemes should be launched by the trusts, and these schemes have to be listed on the stock exchange mentioned in the offer document

   The scheme shall only invest in real estate and the real estate shall generally be income-generating.

4. An independent principal valuer should be appointed who will value all the real estate under the scheme after physical inspection. The valuation methodology shall follow the 'valuation standards on properties' published from time to time by the concerned Indian institute or the international valuation standards issued from time-to-time by the International Valuation Standards Committee.
5. REIT, under all its schemes, should not have exposure to more than 15 per cent of any single real estate project. It can buy uncompleted units in a building, which is unoccupied and non-income producing ,or in the course of development but the aggregate contract value of such real estate should not exceed 20 per cent of the total net asset value of the scheme at the time of acquisition.
6. REIT, under all its schemes, should not have exposure to more than 25 per cent of all the real estate projects developed, marketed, or financed by the same group of companies. The scheme is prohibited from investing in vacant land or participating in property development activities.
7. A scheme may borrow for financing investment or operating purposes but aggregate borrowings shall not at any time exceed one-fifth of the value of total gross assets of the scheme. The scheme may mortgage or pledge its assets to secure such borrowings. The scheme shall disclose in its offer document its borrowing policy including its maximum borrowing limit and the basis for calculating such limit.
8. The scheme shall distribute to unit holders as dividends each year an amount not less than 90 per cent of its annual net income after tax.

Real asset investment trusts and real estate mutual funds will widen options for investors and thereby help in the growth of mutual fund business. According to a study by McKinsey, a consultancy firm, both the products could add $10–14 billion to the asset under management (AUM) by 2012.

RISK AND RETURN IN MUTUAL FUNDS

Risk Mutual fund investments are not free from risk. Equity-oriented mutual funds more risky compared to debt mutual funds. Equity-oriented mutual fund schemes are risky as their returns are market-linked. A fall in the price of equity shares can lead to a fall in the value of equity holdings in the scheme which may result in a fall in the net asset value (NAV). There is wide variety of equity schemes such as diversified equity schemes, index funds, sectoral schemes and equity-linked savings schemes. The proportion of risk varies from scheme to scheme. Sectoral schemes, which invest their funds into shares of a particular sector are considered to be more risky as compared to diversified equity schemes as their investment is concentrated in one sector. In case of index funds, the risk is proportionate to the movement of the index and this movement is reflected in the fund. Equity-linked saving schemes give high returns with high risk (Figure 15.2).

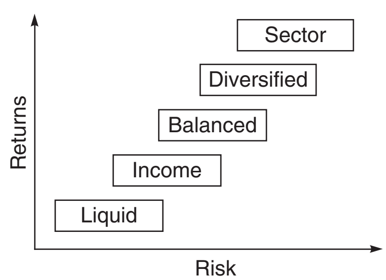


Figure 15.2 Risk vs. Return

Tax Implications for Mutual Fund Investors In the amendments made by the finance minister on July 21, 2004, units of equity oriented mutual funds are to be treated as 'securities'. Thus, transaction in these units attract Securities Transaction Tax (STT) on equity-oriented fund schemes. The transaction tax is payable by the seller at rate of 0.25 per cent on the sale of a unit of an equity-oriented fund to the mutual fund. Trading of units of debt and liquid funds do not attract STT but are liable to capital gains tax. The mutual fund units in case of equity-oriented fund schemes are exempt from long-term capital gains tax and carry a flat rate of 10 per cent short-term capital gains tax.

Divided distribution tax (DDT) is paid by the mutual fund and not its investor. However, the investor indirectly bears the tax burden as it is deducted from the NAV. This results in lower returns to investors.

This tax is applicable only to investors in dividend options of debt-oriented mutual fund schemes. On February 28, 2007, the DDT on liquid and money market funds for individual investors was hiked to 25 per cent (effective rate inclusive of education cess and surcharge around 28.32 per cent), while the tax on other debt funds remained at 12.5 per cent (effective rate inclusive of surcharge 14.2 per cent). For corporates, the DDT on liquid and money market funds was hiked to 25 per cent (effective rate 28.32 per cent) and on other debt funds was hiked to 20 per cent (effective rate 22.66 per cent).

Returns from Mutual Funds

- Equity-oriented schemes are defined as those schemes where the equity holding of the fund in domestic companies is more than 50 per cent. Diversified equity funds and sector funds are examples of equity-oriented schemes.

Dividends Profits earned by the fund is either distributed among unit holders in the form of dividend or is reinvested in the fund. Dividends are reinvested automatically in the dividend reinvestment plan.

- Tax free in the hands of the investor.

Capital Appreciation When the investor books profit by selling the units at prices higher than the purchase price, it is known as capital appreciation.

Equity-oriented Schemes

- Holding period less than 12 months—short-term capital gains tax of 10 per cent.
- Holding period more than 12 months—no long-term capital gains tax but securities transaction tax.

Box 15.3 A Comparison of Investment in Mutual Funds with Investment in Fixed Deposits, Public Provident Fund, Company Fixed Deposit, Equity, and Debenture

In the process of financial planning, an investor has to understand different investment avenues available to him while planning his financial portfolio.

Fixed deposits offer assurance of returns over the tenure of the investment. Moreover, investors can also avail the benefit of writing cheques against fixed deposits and finance through loans against their fixed deposits. An investor can plan out his cash flows as interest and the maturity period is fixed. Fixed deposits have always been popular among all classes of investors as they offer good returns and easy liquidity. Besides, they can be used as collateral security for commercial borrowings. Banks willingly give overdrafts upto 90 per cent of the deposit amount for meeting short-term fund requirements.

But as compared to mutual funds, fixed deposits do not offer the advantages of liquidity, professional management and transparency offered by mutual funds. Moreover, interest is not tax free in case of fixed deposits, while dividend is tax free when investing in mutual funds. Liquid and liquid-plus schemes, which invest in short-term corporate paper (CPs) and government securities such as T-Bills for a period of 60–90 days, offer the benefits of high liquidity and tax arbitrage. The return offered on such schemes is superior to interest rate offered by banks on savings bank accounts. The annual interest rate on savings bank account is 3.5% p.a. while the average return on liquid schemes ranges between 4% and 7% annually. The tax treatment of income on liquid schemes and savings bank account is almost similar. The return on growth option of liquid schemes and interest on bank deposits are taxable according to the income tax slab of the investor. Moreover, investment in liquid schemes enables an investor to transfer money from liquid scheme to other debt or equity schemes.

Public provident funds offer an assured return over the tenure of the investment but do not pay interest as it is accumulated over the tenure. On the other hand, equity-linked saving schemes pay dividends but do not offer assured returns. Life insurance schemes, ELSS, ULIP, five year bank deposits, provident fund and public provident fund, investments in infrastructure bonds, and National Savings Certificates (NSCs) are some of the most common instruments that allow investors to save upto ₹1 lakh on their taxable portion of their income.

Investment in ELSS is more alluring as it has the shortest lock-in period (the maturity for NSC and PPF is 5 and 15 years respectively), yields tax-free dividends, and no capital gains tax to the investor. Moreover, the minimum investment required in ELSS is ₹500, while in case of ULIP, it is ₹10,000 along with higher charges than ELSS.

Company fixed deposits offer a fixed return but as compared to debt funds they are not liquid, interest is taxable, and risk is maximum as the entire investment is in a single company.

With equities, the investor does earn a higher rate of return when markets are buoyant but the uncertainty of returns is quite high and he has to rely on his own knowledge for earning return on equity. Equity mutual funds offer the advantage of diversified investment coupled with professional management which may enable the investor to earn a higher rate of return.

Investment in debentures is secured with a fixed return, but when compared to debt funds they are less liquid and interest is taxable in the hands of the investor.

Debt-oriented Schemes

- Short-term capital gains added to the total income and taxed at the applicable rate of tax for the individual.
- In case of long-term capital gains, the investor has a choice of selecting the rate of 10 per cent flat without using the benefit of indexation or 20 per cent after using the benefits of indexation. Indian tax laws provide a benefit of inflating the cost price of an asset by accounting for inflation, if the asset is held for more than one year, thereby reducing the tax liability of an investor. The Cost Inflation Index (CII) that the government updates every year is used to calculate the actual gains on which the taxes should be paid.

How to Invest in a Scheme of Mutual Fund?

There are around 857 schemes floated by 39 mutual funds. 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 Centers (ISCs) in his particular town or city.

Investor also receives an abridged offer document or the Key Information Memorandum (KIM), which is provided with the application form containing information regarding main features of the scheme, risk factors, initial issue expenses and recurring expenses to be charged to the scheme, entry or exit loads, sponsor's track record, educational qualification and work experience of key personnel including fund managers, performance of other schemes launched by the mutual fund in the past, pending litigations and penalties imposed. The application form for subscription to a scheme is an integral part of the offer document.

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 payouts 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. Investor should design a well-balanced portfolio and rebalance it on a regular basis.

After subscribing to the units of a particular scheme of a mutual fund, he will receive a certificate or statement of accounts within 30 days from the date of closure of the initial public offer of the scheme. An account statement is a document that contains details of the investors; the units allotted or redeemed, NAV on that particular day, and the date of transaction. In case of close-ended schemes, he will receive either a demat account statement or unit certificates within six weeks of the date of closure of the initial subscription of the scheme. An investor must monitor his investments regularly by going through the Fund Fact Sheet- a monthly document published by all mutual funds. This document gives all details as regards the AUMs of all its schemes, top holdings in all the portfolios of all the schemes, loads, minimum investment, performance of the scheme since its launch, comparison of scheme's performance with the benchmark index such as the S&P CNX Nifty, fund manager's outlook, portfolio composition, expense ratio, portfolio turnover, risk adjusted returns, equity/ debt split for schemes, YTM for debt portfolios, and other information which the mutual fund considers important from the investor's decision making point of view.

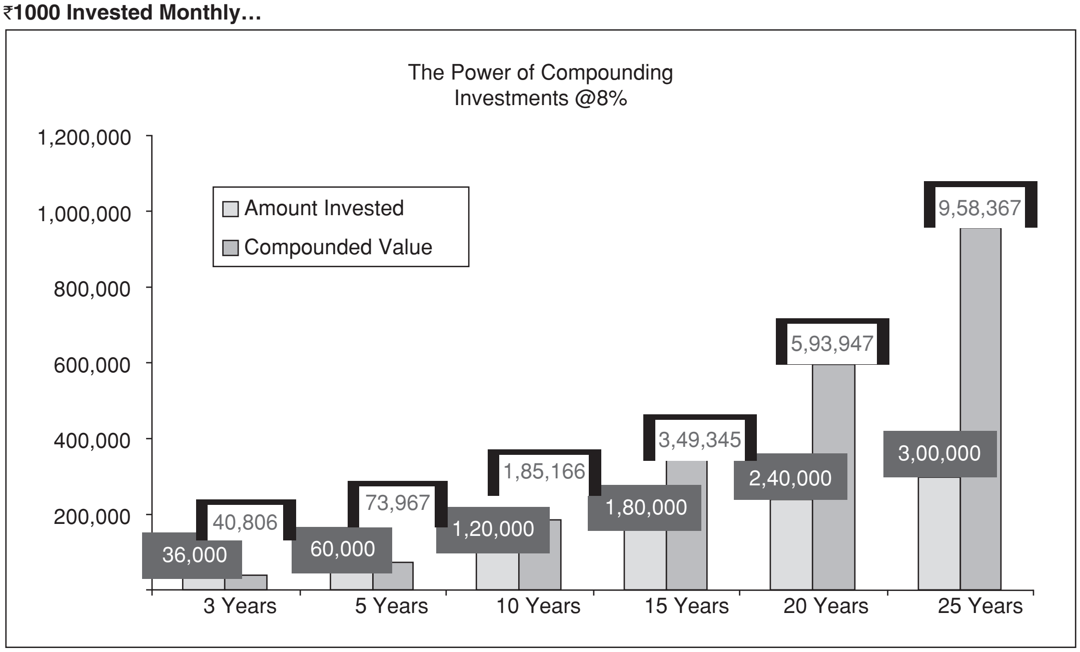
Subsequently, investor will also receive quarterly newsletter from the fund house informing him about any material changes such as changes in the nature or terms of the scheme, conversion of the scheme from close-ended to open-ended and change in sponsor. Fund houses also disclose scheme portfolio on half-yearly basis to their unitholders. These disclosures help the investor to decide the timing of entry and exit in a particular scheme of the mutual fund. Investors are also offered switching facility which provides investors with an option to transfer the funds among different types of schemes or plans. An entry load is charged to an investor switching from a debt scheme to equity scheme while there is no entry load on switching from an equity scheme to a debt scheme.

Methodology of Investment in a Mutual Fund An investor may invest a lumpsum in a particular scheme/s of mutual fund. But he needs to correctly time the market and predicting whether the market is going to move up, down or sideways is difficult even for professionals. If the investment is done when the markets are at high levels, his risk increases on account of volatility of markets. There is an alternative mode of investment available known as **Systematic Investment plans (SIPs).** Instead of making one lumpsum investment, an investor may put in a fixed sum of money each month, over a period of time regardless of the mutual fund's unit price. Under this plan a fixed sum of money is invested periodically in equity and equity-oriented mutual fund schemes. This plan avoids the problem of market timing and usually gives high returns if the investor has a long-term investment horizon. Hence, through the power of compounding, this plan usually does well in the long run (Refer Figure 15.3).

Systematic investment plan (SIP) is a popular investment strategy employed by a large mass of investors.

- As the minimum of investment is ₹500 every month, this plan attracts investors of diverse income groups.
- Regular commitment of investment of small amount for longer duration. Investing a small amount every month or every quarter results in forced savings.

₹1000 Invested Monthly…



Investing Even a Small Amount Regularly, Helps Create Wealth

Figure 15.3 Regular Investment Benefits

Box 15.4 Rupee-Cost Averaging when Unit Prices are Volatile

Month	*Amount Invested*	*Unit Price*	*No. of Units Purchased*
01-Jan	₹1,000	₹24	41.67
01-Feb	₹1,000	₹21	47.62
01-Mar	₹1,000	₹25	40.00
01-Apr	₹1,000	₹16	62.50
01-May	₹1,000	₹20	50.00
01-Jun	₹1,000	₹21	47.62
	Total: ₹6000	**Avg. Cost: ₹20.73**	**Total: 289.41**

- Skill of timing the market is not required because an investor is investing at all levels. Through disciplined, regular investments an investor has not to worry about when and how much to invest.
- Equity market moves both sides so he gets the benefit of averaging out the cost of purchase.
- Investing regularly, irrespective of market behavior, helps manage volatility. Investing a small amount every month brings down the risk. Also, more the volatility more chances of returns.

A fixed amount invested regularly buys more units when the price is low and fewer when the price is high, which can mean a lower average cost per unit over a period of time- this concept is known as Rupee Cost Averaging. Let us understand this with help of an illustration.

Following is the NAV of a mutual fund scheme on the first of each month from January to June-₹24, ₹21, ₹18, ₹16, ₹16 and ₹12 respectively. Looking to the trend, we observe that NAV of this scheme is volatile. Suppose there are two investors: Mr. A and Mr. B. Both have invested ₹6000 in this scheme. Mr. A has invested ₹6000 on January 1, at a unit price of ₹24 and he has been allotted 250 units.

Mr. B has invested ₹1000 on the first of each month for six months. He has acquired 289.41 units at an average cost of ₹20.73 each. The investment's value at the end of the period would be ₹6077.61 (289.41*21) (Box 15.4) much higher than that of Mr. A's investment value which is ₹5250 (250 units *21).

Now, SIPs come with free life insurance cover to investors. Through this, mutual fund houses aim to induce a long-term savings habit among investors. To earn higher returns, investors need to choose the right scheme. Investment through SIP will lose value if invested in a wrong scheme.

Some mutual fund houses such as UTI Asset Management, SBI Mutual Fund, ICICI Prudential, and Bharti AXA have started micro SIPs in their bid to reach out to the large masses who cannot afford ₹500 SIP. The SBI Mutual Fund offers a 'chota SIP' starting at ₹100 targeting farmers and daily wage earners. This scheme will create an awareness of the benefits of savings and financial planning among low-income groups.

Mutual funds also give facilities of systematic withdrawals and systematic transfer of funds to investors. Depending on an investor's needs for monthly or quarterly income, he can then choose to withdraw either a fixed sum per month or quarter, or the capital appreciation in the Net Asset Value of his investment. A **systematic withdrawal plan (SWP)** enables an investor to take money out of a fund account according to a regular schedule that he chooses. If the investor desires to transfer money from one scheme to another, then there is another plan available known as **Systematic transfer plan (STP).** An STP enables an investor to switch or transfer a fixed amount of money at regular intervals from his fixed income scheme investments to designated equity and balanced schemes. In effect, this is similar to a systematic investment plan, except that in a SIP the investment flows from a bank account into the fund and here it flows from one scheme to another.

- SIP—An investor commits to invest in a scheme at regular intervals.
- STP—An investor transfers a fixed amount of money or appreciation on the unit value in one scheme to another at regular intervals for profit booking or exposure to a new asset class.
- SWP—An investor redeems a fixed sum or specific number of units at regular intervals without getting exposed to timing risk.

SEBI GUIDELINES RELATING TO MUTUAL FUNDS

The mutual funds are registered and regulated under the SEBI (MF) regulations, 1996. These regulations deal with launching of schemes, disclosures in the offer document, advertisements, investment objectives, pricing of units and other related aspects. SEBI regulates structure, market and investor-related activities of mutual funds. But issues concerning the ownership of the AMCs by banks fall under the regulatory preview of the RBI.

Mutual Fund Schemes

1. All the schemes to be launched by the AMC need to be approved by the trustees and copies of offer documents of such schemes are to be filed with the SEBI. The offer document shall have two parts: Scheme Information Document (SID) and Statement of Additional Information (SAI). SID shall incorporate all information pertaining to a particular scheme. SAI shall incorporate all statutory information on mutual fund.
2. The offer documents shall contain adequate disclosures to enable the investors to make informed decisions including the disclosure on maximum investments proposed to be made by the scheme in the listed securities of the group companies of the sponsor.
3. The SEBI may in the interest of investors require the asset management company to carry out such modifications in the offer document as it deems fit. In case no modifications are suggested by it in the offer document within 21 workingdays from the date of filing, the asset management company may issue the offer document. The offer document shall contain the disclosure regarding the prior in principle approval obtained from the recognized stock exchange(s), where units are proposed to be listed in accordance with these regulations.
4. Advertisements in respect of schemes should be in conformity with the SEBI prescribed advertisement code, and shall be submitted to the regulator within 7 days from the date of issue. The advertisement for each scheme shall disclose investment objective of each scheme. The offer document and advertisement materials shall not be misleading or contain any statement or opinion which are incorrect or false.
5. The listing of close-ended schemes, other than an equity linked savings scheme, is mandatory and every close-ended scheme should be listed on a recognized stock exchange within within such time period and subject to such conditions as specified by the SEBI. However, listing is not mandatory in case the scheme provides for monthly income or caters to the special classes of persons like senior citizens, women, children, and the physically handicapped; if the scheme discloses details of repurchase in the offer document; if the scheme opens for repurchase within six months of closure of subscription. if the scheme provides for periodic repurchase facility to all the unitholders with restriction, if any, on the extent of such repurchase; if the scheme is a capital protection oriented scheme.
6. Units of a close ended scheme, other than those of an equity linked savings scheme, launched on or after the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 shall not be repurchased before the end of maturity period of such scheme. The units of close ended schemes may be open for sale or redemption at fixed predetermined intervals if the maximum and minimum amount of sale or redemption of the units and the periodicity of such sale or redemption have been disclosed in the offer document.
7. The units of close ended scheme may be converted into open-ended scheme:
   a. if the offer document of such scheme discloses the option and the period of such conversion; or
   b. the unitholders are provided with an option to redeem their units in full *and*
   c. the initial issue expenses of the scheme launched prior to commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2008 have been amortised fully in accordance with the Tenth Schedule.
8. A close ended scheme shall be fully redeemed at the end of the maturity period provided that a close-ended scheme may be allowed to be rolled over if the purpose, period and other terms of the roll over and all other material details of the scheme including the likely composition of assets immediately before the roll over, the net assets and net asset value of the scheme, are disclosed to the unitholders and a copy of the same has been filed with the regulator.

   Provided further that such roll over will be permitted only in the case of those unitholders who express their consent in writing and the unitholders who do not opt for the roll over or have not given written consent shall be allowed to redeem their holdings in full at net asset value based price.
9. No scheme of a mutual fund other than the initial offering period of any equity linked savings schemes shall be open for subscription for more than 45 days.
10. The asset management company shall specify in the offer document:
    a. the minimum subscription amount it seeks to raise under the scheme; and
    b. in case of oversubscription the extent of subscription it may retain:

       Provided that where the asset management company retains the oversubscription referred to in clause (*b*), all the applicants applying upto five thousand units shall be given full allotment subject to the oversubscription mentioned in clause (*b*).

The mutual fund and asset management company shall be liable to refund the application money to the applicants:

i. if the mutual fund fails to receive the minimum subscription amount referred to in clause (*a*);
ii. if the moneys received from the applicants for units are in excess of subscription as referred to in clause (*b*).

Any amount refundable shall be refunded within a period of six weeks from the date of closure of subscription list, by Registered post with acknowledgement due and by cheque or demand draft marked 'A/c payee' to the applicants.

In the event of failure to refund the amounts within the period specified, the asset management company shall be liable to pay interest to the applicants at a rate of fifteen per cent per annum from the expiry of six weeks from the date of closure of the subscription list.

11. The asset management company shall issue to the applicant whose application has been accepted, a statement of accounts specifying the number of units allotted to the applicant as soon as possible but not later than thirty days from the date of closure of the initial subscription list and/or from the date of receipt of the request from the unit holders in any open ended scheme:

    Provided that if an applicant so desires, the asset management company shall issue the unit certificates to the applicant within thirty days of the receipt of request for the certificate.

    An applicant in a close ended scheme whose application has been accepted shall have the option either to receive the statement of accounts or to hold units in dematerialized form and the asset management company shall issue to such applicant, a statement of accounts specifying the number of units allotted to the applicant or issue units in dematerialized form as soon as possible but not later than thirty days from the date of closure of the initial subscription list.

    The asset management company shall issue units in dematerialized form to a unitholder in a close ended scheme listed on a recognized stock exchange within two working days of the receipt of request from the unitholder.
12. No guaranteed return shall be provided in a scheme:
    a. unless such returns are fully guaranteed by the sponsor or the asset management company;
    b. unless a statement indicating the name of the person who will guarantee the return, is made in the offer document;
    c. the manner in which the guarantee is to be met has been stated in the offer document.
13. A close-ended scheme shall be wound up on the expiry of duration fixed in the scheme on the redemption of the units unless it is rolled over for a further period.

    A scheme of a mutual fund may be wound up, after repaying the amount due to the unit holders,—
    a. on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound up; or
    b. if 75 per cent of the unit holders of a scheme pass a resolution that the scheme be wound up; or
    c. if the regulator so directs in the interest of the unitholders.

    Where a scheme is to be wound up, the trustees shall give notice disclosing the circumstances leading to the winding up of the scheme:
    i. to the regulator; and
    ii. in two daily newspapers having circulation all over India, a vernacular newspaper circulating at the place where the mutual fund is formed.

Investment Objective

1. Subject to other provisions of these regulations, a mutual fund may invest funds collected under any of its schemes only in
    a. securities;
    b. money market instruments;
    c. privately placed debentures;
    d. securitized debt instruments, which are either asset backed or mortgage backed securities;
    e. gold or gold related instruments;
    f. real estate assets.
2. Any investment made shall be in accordance with the investment objective of the relevant mutual fund scheme. Funds collected under any money market scheme of a mutual fund shall be invested only in money market instruments. Funds collected under any gold exchange traded fund scheme shall be invested only in gold or gold related instruments. Funds collected under a real estate mutual fund scheme shall be invested in accordance with SEBI regulation.

3. The mutual fund shall not borrow except to meet temporary liquidity needs of the mutual funds for the purpose of repurchase, redemption of units or payment of interest or dividend to the unitholders:
   Provided that the mutual fund shall not borrow more than 20 per cent of the net asset of the scheme and the duration of such a borrowing shall not exceed a period of six months.
4. The mutual fund shall not advance any loans for any purpose.
5. A mutual fund may lend and borrow securities and enter into short selling transactions on a recognized stock exchange, in accordance with the SEBI specified framework relating to short selling and securities lending and borrowing.
6. The funds of a scheme shall not in any manner be used in carry forward transactions:
   Provided that a mutual fund may enter into derivatives transactions on a recognized stock exchange, subject to the SEBI specified framework.
7. Mutual funds may enter into underwriting agreement after obtaining a certificate of registration in terms of the Securities and Exchange Board of India (Underwriters) Rules and Securities and Exchange Board of India (Underwriters) Regulations, 1993 authorising it to carry on activities as underwriters. The underwriting obligation will be deemed as if investments are made in such securities and the capital adequacy norms for the purpose of underwriting shall be the net asset of the scheme:
   Provided that the underwriting obligation of a mutual fund shall not at any time exceed the total net asset value of the scheme.
8. Every mutual fund shall compute and carry out valuation of its investments in its portfolio and publish the same in accordance with the SEBI specified valuation norms.

Pricing of Units

1. The price at which the units may be subscribed or sold and the price at which such units may at any time be repurchased by the mutual fund shall be made available to the investors.
2. The mutual fund, in case of open-ended scheme, shall at least once a week publish in a daily newspaper of all India circulation, the sale and repurchase price of units.
3. While determining the prices of the units, the mutual fund shall ensure that the repurchase price is not lower than 93 per cent of the Net Asset Value and the sale price is not higher than 107 per cent of the Net Asset Value:
   Provided that the repurchase price of the units of close ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009 shall not be lower than ninety five per cent of the Net Asset Value:
   Provided further that the difference between the repurchase price and the sale price of the unit shall not exceed 7 per cent calculated on the sale price.
4. Where a mutual fund repurchases units in a close ended scheme launched prior to the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2009, it shall deduct an amount representing proportionate initial issue expenses or part thereof remaining unamortized, from the repurchase proceeds. The term 'proportionate initial issue expenses or part thereof remaining unamortized' refers to such proportion of the expenses of the scheme as are attributable to the units being repurchased.

Settlement System T+1 settlement system for liquid schemes of domestic mutual funds was implemented from October 16, 2006. As per this new settlement cycle, the payment for redemption of scheme units by an investor will happen only the next day. The settlement system is in line with the settlement system in the government securities market.

Investment by Schemes

Investments by Index Funds Investments by index funds shall be in accordance with the weightage of the scrips in the specific index as disclosed in the SID. In case of sector or Industry specific scheme, the upper ceiling on investments may be in accordance with the weightage of the scrips in the representative sectoral index or sub index as disclosed in the SID or 10% of the NAV of the scheme, whichever is higher.

Investments by Liquid Schemes and Plans The 'liquid fund schemes and plans' shall make investment in/purchase debt and money market securities with maturity of upto 91 days only. This shall also be applicable in case of inter scheme transfer of securities.

Investments by Close Ended Debt Schemes Close ended debt schemes shall invest only in such securities which mature on or before the date of the maturity of the scheme.

Stock Lending Scheme The following guidelines are issued to facilitate lending of securities by Mutual Funds through intermediaries approved by the SEBI in accordance with the Stock Lending & Borrowing Scheme.

Disclosure Requirements

The following information shall be disclosed in the SID to enable the investors and unit holders to take an informed decision:

1. Intention to lend securities belonging to a particular Mutual Fund scheme in accordance with the guidelines on securities lending and borrowing scheme issued by SEBI from time to time.
2. Exposure limit with regard to securities lending, both for the scheme as well as for a single intermediary.
3. Risks factors such as loss, bankruptcy etc. associated with such transactions.

Reporting Requirement

The AMC(s) shall report to the Trustees on a quarterly basis about the level of lending, in terms of value, volume and intermediaries and also earnings and/or losses, value of collateral security etc.

The Trustees shall periodically review the securities lending contract and take reasonable steps to ensure that the same is not, in any way, detrimental to the interests of the unit holders of the scheme. The Trustees shall offer their comments on the above aspects in the Half Yearly Trustee Report filed with the SEBI.

Existing Schemes

In case an existing Scheme Information Document (SID) does not provide for lending of securities, Mutual Funds may still lend securities belonging to the scheme, in accordance with the SEBI Guidelines, provided approval is obtained from the Trustees and the intention to lend securities is conveyed to the unit holders.

Approval for Investment in Unrated Debt Instruments Mutual Funds may, for the purpose of operational flexibility, constitute committees to approve investment proposals in unrated instruments. However, detailed parameters for investment in unrated debt instruments have to be approved by the Board of the AMC and Trustees.

Details of such investments shall be communicated by the AMCs to the Trustees in their periodical reports, along with clear indication as to how the parameters set for investments have been complied with. Prior approval of the Board of the AMC and Trustees shall be required in case investment is sought to be made in an unrated security falling outside the prescribed parameters.

Investments in Units of Venture Capital Funds Mutual Fund schemes can invest in listed or unlisted securities or units of Venture Capital Funds within the prescribed investment limits as applicable.

Investment Limits for Government Guaranteed Debt Securities Prudential investment norms as per Regulations stipulating limits for investments in debt securities issued by a single issuer are applicable to all debt securities issued by public bodies or institutions such as electricity boards, municipal corporations, state transport corporations etc. guaranteed by either State/Central Government. Government securities issued by Central and/or State Government or on its behalf, by the RBI are however exempt from these limits.

Investments in Short Term Deposits of Scheduled Commercial Banks The guidelines for deployment of funds in short term deposits of commercial banks for schemes are as under: “Short Term” for parking of funds by Mutual Funds shall be treated as a period not exceeding 91 days. Such deposits shall be held in the name of the concerned scheme.

Mutual Funds shall not park more than 15% of their net assets in short term deposits of all scheduled commercial banks put together. This limit however may be raised to 20% with prior approval of the Trustees. Also, parking of funds in short term deposits of associate and sponsor scheduled commercial banks together shall not exceed 20% of the total deployment by the Mutual Fund in short term deposits. Mutual Funds shall not park more than 10% of the net assets in short term deposits with any one scheduled commercial bank including its subsidiaries.

Trustees shall ensure that funds of a particular scheme are not parked in short term deposit of a bank which has invested in that scheme.

In case of liquid and debt oriented schemes, AMC(s) shall not charge any investment management and advisory fees for parking of funds in short term deposits of scheduled commercial banks. Half Yearly portfolio statements shall disclose all funds parked in short term deposit(s) under a separate heading. Details shall also include name of the bank, amount of funds parked, percentage of NAV. Trustees shall, in the Half Yearly Trustee Reports certify that provisions of the Mutual Funds Regulations pertaining to parking of funds in short term deposits pending deployment are complied with at all points of time. The AMC(s) shall also certify the same in its Compliance test reports (CT₹). Investments made in short term deposits pending deployment of funds shall be recorded and reported to the Trustees including the reasons for the investment especially comparisons with interest rates offered by other scheduled commercial banks.

Other Aspects

- In order to check unethical practices like ‘late trading’, SEBI has fixed the daily schedules for mutual funds for NAV-based sales and redemption of their schemes. Sale and redemption requests for all schemes except liquid funds, made before 3 p.m. shall be at the closing NAV of the same day. For all outstation instruments, the next day’s NAV shall be applicable. For liquid schemes, all requests received till 10 a.m. should be at the previous day’s NAV and thereafter, at the day’s closing NAV. For purchases in these schemes, the NAV of the day immediately previous to the day on which the funds were received by the MF should be used. In case, the funds are received after 1 p.m., the day’s closing NAV should be used. These rules for cut-off timings are not applicable to funds with substantial exposure to stocks traded in international markets and funds traded on the stock exchange.
- The SEBI found that many mutual fund schemes were tailor made for corporates, or high net worth individuals who were using the mutual fund investment route to save on income tax. These norms were issued in November 2003, to check the abuse of the mutual fund vehicle by large corporate investors for tax benefits. The new norms stipulate that each mutual fund scheme should have atleast 20 investors and no single investor should hold more than 25 per cent of the total corpus of the scheme.
- The PAN is now the sole identification for all market participants with appropriate affix or suffix to identify the nature of investment product , irrespective of the amount of transaction, effective July 2, 2007.
- Every mutual fund should be and sell securities on delivery basis. A mutual fund many engage in short-selling of securities and enter into derivatives transactions in accordance with the framework specified by the SEBI.

Overseas Investments by Mutual Funds

Mutual Funds were permitted to invest in ADRs/GDRs/foreign securities in September 2005 subject to a ceiling of US $1 billion. The aggregate ceiling for the mutual-fund industry to invest in ADRs/GDRs issued by Indian companies, equity of overseas companies listed on recognized stock exchanges overseas and rated debt securities (foreign securities) was raised from US $1 billion to US $2 billion in the Finance Bill

1. Applicable Limits
   a. The aggregate ceiling for overseas investments is US $7 billion.
   b. Within the overall limit of US $7 billion, mutual funds can make overseas investments subject to a maximum of US $300 million per mutual fund.
2. Mutual Funds can invest in permissible investments
   a. ADRs/GDRs issued by Indian or foreign companies
   b. Equity of overseas companies listed on recognized stock exchanges overseas
   c. Initial and follow on public offerings for listing at recognized stock exchanges overseas

d. Foreign debt securities in the countries with fully convertible currencies, short term as well as long term debt instruments with rating not below investment grade by accredited/registered credit rating agencies
e. Money market instruments rated not below investment grade
f. Repos in the form of investment, where the counterparty is rated not below investment grade; repos should not however, involve any borrowing of funds by mutual funds
g. Government securities where the countries are rated not below investment grade
h. Derivatives traded on recognized stock exchanges overseas only for hedging and portfolio balancing with underlying as securities
i. Short term deposits with banks overseas where the issuer is rated not below investment grade
j. Units/securities issued by overseas mutual funds or unit trusts registered with overseas regulators and investing in:
   i. aforesaid securities,
   ii. Real Estate Investment Trusts (REITs) listed in recognized stock exchanges overseas or (c) unlisted overseas securities (not exceeding 10% of their net assets).

3. Limits for Investment in Overseas Exchange Traded Funds (ETFs) The overall ceiling for investment in overseas ETFs that invest in securities is US $ 1 billion subject to a maximum of US $50 million per mutual fund.
4. Other Conditions: Apart from applicability of SEBI (Mutual Funds) Regulations, 1996 and guidelines issued from time to time, the mutual funds shall adhere to the following specific guidelines for making overseas investments by the mutual fund schemes:
   a. Appointment of a Dedicated Fund Manager: The Mutual Fund shall appoint a Dedicated Fund Manager for making overseas investments stipulated under para 2 (i) (ix) above.
   b. Due Diligence: Boards of Asset Management Companies (AMCs) and Trustees shall exercise due diligence in making investment decisions. They shall make a detailed analysis of risks and returns of overseas investment and how these investments would be in the interest of investors. Investment must be made in liquid actively traded securities/instruments. Boards of AMCs and Trustees may prescribe detailed parameters for making such investments which may include identification of countries, country rating, country limits, etc. They shall satisfy themselves that the AMC has experienced key personnel, research facilities, and infrastructure for making such investments. Other specialized agencies and service providers associated with such investments e.g. custodian, bank, advisors, etc. should also have adequate expertise and infrastructure facilities. Their past track record of performance and regulatory compliance record, if they are registered with foreign regulators, may also be considered. Necessary agreements may be entered into with them as considered necessary.
   c. Disclosure Requirements: The following disclosure requirements shall be mandatory for mutual fund schemes proposing overseas investments:
      i. Intention to invest in foreign securities/ETFs shall be disclosed in the offer documents of the schemes. The attendant risk factors and returns ensuing from such investments shall be explained clearly in offer documents. The mutual funds shall also disclose as to how such investments will help in the furtherance of the investment objectives of the schemes. Such disclosures shall be in a language comprehensible to an average investor in mutual funds.
      ii. The mutual funds shall disclose the name of the Dedicated Fund Manager for making overseas investments.
      iii. The mutual funds shall disclose exposure limits *i.e.*, the percentage of assets of the scheme they would invest in foreign securities/ETFs.
      iv. Such investments shall be disclosed while disclosing half-yearly portfolios in the prescribed format by making a separate heading 'Foreign Securities/overseas ETFs.' Scheme-wise percentage of investments made in such securities shall be disclosed while publishing half-yearly results in the prescribed format, as a footnote.
   d. Investment by Existing Schemes: Existing schemes of mutual funds where the offer document provides for investment in foreign securities and attendant risk factors but which have not yet invested, may invest in foreign securities, consistent with the investment objectives of the schemes, provided that for making overseas investments stipulated a dedicated Fund Manager has been appointed. Additional disclosure as specified above shall be included by way of addendum and unit holders will be informed accordingly. In case the offer document of an existing scheme does not provide for overseas investment, the scheme, if it so desires, may make such investments in accordance with these guidelines, provided that: prior to overseas

investments for the first time, the AMC shall ensure that a written communication about the proposed investment is sent to each unitholder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the mutual fund is situated. The communication to unitholders shall also disclose the risk factors associated with such investments.

Indian mutual funds have invested only $1.5 bn (₹6,000 crore) in overseas markets so far. Among the eight mutual funds which have launched special schemes for investment in overseas securities, the largest is DSP World Gold Fund that has assets under management of over ₹1,760 crore. Many mutual fund houses have launched hybrid funds which invest about 65 per cent in India and the balance 35 per cent in overseas securities because of tax considerations. Investment in overseas markets helps investors diversify their portfolio and deliver better returns.

THE ASSOCIATION OF MUTUAL FUNDS IN INDIA

The Association of Mutual Funds in India (AMFI) was established in 1993 when all the mutual funds, except the UTI, came together realizing the need for a common forum for addressing the issues that affect the mutual fund industry as a whole. The AMFI is dedicated to developing the Indian mutual fund industry on professional, health, and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders.

Objectives of AMFI

- To define and maintain high professional and ethical standards in all areas of operation of the mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management, including agencies connected or involved in the field of capital markets and financial services.
- To interact with the SEBI and to represent to the SEBI on all matters concerning the mutual fund industry.
- To represent to the government, the RBI, and other bodies on all matters relating to the mutual fund industry.
- To develop a cadre of well-trained agent distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.
- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund industry and to undertake studies and research directly and/or in association with other bodies.

AMFI continues to play its role as a catalyst for setting new standards and refining existing ones in many areas, particularly in the sphere of valuation of securities. Based on the recommendations of the AMFI, detailed guidelines have been issued by the SEBI for valuation of unlisted equity shares.

A major initiative of the AMFI during the year 2001–02 was the launching of registration of AMFI Certified Intermediaries and providing recognition and status to the distributor agents. More than 30 corporate distributors and a large number of agent distributors have registered with the AMFI. The AMFI Guidelines and Norms for Intermediaries (AGNI) released in February 2002, gives a framework of rules and guidelines for the intermediaries and for the conduct of their business.

AMFI maintains a liaison with different regulators such as the SEBI, the IRDA, and the RBI to prevent any over-regulation that may stifle the growth of the industry. AMFI has set up a working group to formulate draft guidelines for pension scheme by mutual funds for submission to IRDA. It holds meetings and discussions with the SEBI regarding matters relating to the mutual fund industry. Moreover, it also makes representations to the government for removal of constraints and bottlenecks in the growth of the mutual fund industry.

AMFI recently launched appropriate market indices which will enable investors to appreciate and make meaningful comparison of the returns of their investments in mutual funds schemes. While in the case of equity funds, a number of benchmarks like the BSE Sensex and the S&P CNX Nifty are available, there was a lack of relevant benchmarks for debt funds. AMFI took the initiative of developing eight new indices jointly with *Crisil.com* and ICICI Securities. These indices have been constructed to benchmark the performance of different types of debt schemes such as liquid, income, monthly income, balanced fund, and gilt fund schemes. These eight new market indices are the Liquid Fund Index (Liqui fex), the Composite Bond Fund Index (Compbex), the Balanced Fund Index (Balance EX), the MIP Index (MIPEX), the Short Maturity Gilt Index (Si-Bex), the Medium Maturity Gilt Index (Mi-Bex), the Long Maturity Gilt Index (Li-Bex), and the Composite Gilt Index.

In the case of liquid funds, the index comprises a commercial paper (CP) component with a 60 per cent weightage and an inter-bank call money market component with a 40 per cent weightage. The CP component of the index is computed using the weighted average issuance yield on new 91 days CPs issued by top rated manufacturing companies. In the case of bond funds, the index comprises a corporate bond component with a 55 per cent weightage, gilts component with a 30 per cent weightage call component with a 10 per cent weightage and commercial paper with a 5 per cent weightage. The index's 55 per cent bond component is split based on a 40 point share of AA rated bonds, and 15 points share of AA rated bonds.

Mutual funds have now to disclose also the performance of appropriate market indices alongwith the performance of schemes both in the offer document and in the half-yearly results. Further, the trustees are required to review the performance of the schemes on periodical basis with reference to market indices. These indices will be useful to distribution companies, agents/brokers, financial consultants, and investors.

AMFI conducts investor awareness programmes regularly. AMFI also conducts intermediaries certification examination.

The Association of Mutual Funds in India (AMFI) has in principle agreed to become a self regulatory organization (SRO) with limited regulatory responsibilities relating to sales practices and codes of conduct. AMFI is in the process of becoming a self-regulatory organization (SRO). It has set up a committee to set the norms for the AMFI to become an SRO. AMFI should act as an SRO in limited areas such as valuation, disclosures and also in regulating distributors of agents registered with it.

UNIT TRUST OF INDIA

The Unit Trust of India (UTI) is India's first mutual fund organization. It is the single largest mutual fund in India which came into existence with the enactment of the UTI Act in 1964.

The economic turmoil and the wars in the early 1960s depressed the financial markets, making it difficult for both existing and new entrepreneurs to raise fresh capital. The then Finance Minister, T. T. Krishnamachari, set up the idea of a Unit Trust which would mobilize savings of the community and invest these savings in the capital market. His ideas took the form of the Unit Trust of India, which commenced operations from July 1964 'with a view to encouraging savings and investment and participation in the income, profits and gains accruing to the corporation from the acquisition, holding, management and disposal of securities'. The regulations passed by the Ministry of Finance (MoF) and the parliament from time to time regulated the functioning of UTI. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the trust as well as accounting, disclosures, and regulatory requirements for the trust.

UTI was set up as a trust without ownership capital and with an independent board of trustees. The board of trustees manages the affairs and business of UTI. The board performs its functions, keeping in view the interest of the unit holders under various schemes.

UTI has a wide distribution network of 54 branch offices, 266 chief representatives and about 67,000 agents. These chief representatives supervise agents. UTI manages 72 schemes and has an investor base of 20.02 million investors. UTI has set up 183 collection centres to serve investors. It has 57 franchisee offices which accept applications and distribute certificates to unit holders.

UTI's mission statement is to meet the investor's diverse income and liquidity needs by creation of appropriate schemes; to offer best possible returns on his investment, and render him prompt and efficient service, beyond normal customer expectations.

UTI was the first mutual fund to launch India Fund, an offshore mutual fund in 1986. The India Fund was launched as a close-ended fund but became a multi-class, open-ended fund in 1994. Thereafter, UTI floated the India Growth Fund in 1988, the Columbus India Fund in 1994, and the India Access Fund in 1996. The India Growth Fund is listed on the NYSE. The India Access Fund is an Indian Index Fund, tracking the NSE 50 index.

UTI's Associates

UTI has set up associate companies in the fields of banking, securities trading, investor servicing, investment advice, and training, towards creating a diversified financial conglomerate and meeting investors' varying needs under a common umbrella.

UTI Bank Limited UTI Bank was the first private sector bank to be set up in 1994. The bank has a network of 121 fully computerized branches spread across the country. The bank offers a wide range of retail, corporate, and forex services. UTI Bank is now rechristened as Axis Bank.

UTI Securities Exchange Limited UTI Securities Exchange Limited was the first institutionally sponsored corporate stock broking firm incorporated on June 28th, 1994, with a paid-up capital of ₹300 million: It is wholly owned by UTI and promoted to provide secondary market trading facilities, investment banking, and other related services. It has acquired membership of the NSE, the BSE, the OTCEI, and the Ahmedabad Stock Exchange (ASE).

UTI Investor Services Limited UTI Investor Services Limited was the first institutionally sponsored registrar and transfer agency set up in 1993. It helps UTI in rendering prompt and efficient services to the investors.

UTI Institute of Capital Markets UTI Institute of Capital Market was set up in 1989 as a non-profit educational society to promote professional development of capital market participants. It provides specialized professional development programmes for the varied constituents of the capital market and is engaged in research and consultancy services. It also serves as a forum to discuss ideas and issues relevant to the capital market.

UTI Investment Advisory Services Limited UTI Investment Advisory Services Limited, the first Indian investment advisor registered with SEC, US, was set up in 1988 to provide investment research and back office support to other offshore funds of UTI.

UTI International Limited UTI International Limited is a 100 per cent subsidiary of UTI, registered in the island of Guernsey, Channel Islands. It was set up with the objective of helping in the UTI offshore funds in marketing their products and managing funds. UTI International Limited has an office in London, which is responsible for developing new products, new business opportunities, maintaining relations with foreign investors, and improving communication between UTI and its clients and distributors abroad.

UTI has a branch office at Dubai, which caters to the needs of NRI investors based in six Gulf countries, namely, UAE, Oman, Kuwait, Saudi Arabia, Qatar, and Bahrain. This branch office acts as a liaison office between NRI investors in the Gulf and UTI offices in India.

UTI has extended its support to the development of unit trusts in Sri Lanka and Egypt. It has participated in the equity capital of the Unit Trust Management Company of Sri Lanka.

The strategic investments of UTI include UTI's equity holdings in IL & FS where it has a stake of 26.98 per cent, the NSE where it is a founder-promoter, and the credit rating agencies—CRISIL and ICRA where its holding is below 10 per cent. UTI-I also houses the equity holding of 33 per cent in UTI Bank. Most of the assured return schemes of the erstwhile UTI have been redeemed by UTI-I. This leaves UTI-I with management of subsidiaries and investment as mentioned above.

Promotion of Institutions

The Unit Trust of India has helped in promoting/co-promoting many institutions for the healthy development of financial sector. These institutions are:

- Infrastructure Leasing and Financial Services (ILFS)
- Credit Rating and Information Services Limited (CRISIL)
- Stock Holding Corporation of India Limited (SHCIL)
- Technology Development Corporation of India Limited (TDCIL)
- Over the Counter Exchange of India Limited (OCEI)
- National Securities Depository Limited (NSDL)
- North-Eastern Development Finance Corporation Limited (NEDFCL)

US-64

UTI launched its first scheme, Unit Scheme 1964 (US-64), with the aim of inculcating the habit of saving among households. The initial sponsors of the scheme were the RBI, Life Insurance Corporation (LIC), State Bank of India (SBI), and other scheduled banks, including a few foreign banks. They contributed to its initial capital of ₹ five crore. In February 1976, RBI's contribution was taken up by the Industrial Development Bank of India (IDBI). These institutions were provided representation on the Board of the Trustees of UTI. The US-64 is the flagship scheme of UTI which commands around one-fifth of UTI's total assets. Around 20 million investors have invested in the scheme. This scheme ran into trouble in 1998.

The US-64 was launched as a debt fund as the equity markets were not developed in the sixties. Its repurchase and sale price are administered, *i.e.*, fixed by UTI at the beginning of its financial year (July for UTI). Both the repurchase and sale price used to consistently increase by the end of the year, irrespective of the actual returns generated and assets under management. This administered pricing was not a problem in a bullish market but if the markets turned bearish, this high price was paid out of reserves. Thus, arbitrary fixing of rates and repurchase of the units combined with high dividend payments depleted the reserves and turned them negative to the tune of ₹1,098 crore. The government came up with a bailout package in the form of Special Unit Scheme (SUS-1999). In 1999, the UTI issued to the government special units of SUS-99 worth the book value. In turn, the government issued dated securities worth ₹3,300 crore to take over the scrips of public sector undertakings (PSUs) from the US-64 scheme. The government lost ₹1,000 crore due to the depreciation in the value of public sector undertakings stocks that were exchanged during the bailout under the SUS-99. This bailout improved the NAV of US-64 but highlighted the inherent problems of UTI such as political interventions in the investment decisions of UTI and a total lack of accountability.

UTI is governed by a special act and hence did not come under the purview of the SEBI. There was no regulator to ensure the soundness of UTI's investment decisions. The small investors' interest in the scheme was mainly due to the higher returns it generated and dividends it declared and, above all, backed by the government. They were never bothered about the functioning of UTI. UTI never made it a practice to disclose any qualitative information to the investors. In fact, UTI continued to float a series of schemes with assured returns and followed liberal dividend policies. These assured return schemes with high dividend pay-out were no longer practical.

In 1993–94, the income from the US-64 scheme was ₹3,538 crore while the dividend outflow was ₹3,128 crore. However, the dividend outflow started exceeding its income from the financial year 1994–95 and continued till 1996–97. In 1994–95, the dividend outflow was ₹3,973 crore as against the income of ₹3,287 crore. This depleted the reserves of UTI which dropped from ₹5,842 crore in 1993–94 to ₹1,778 crore in 1996–97 and finally turned negative by ₹1,098 crore in 1998. With a view to building up reserves, UTI reduced its dividend rate from 20 per cent to 13.5 per cent in 1998–99. The 10 per cent dividend that UTI declared in 2001 was the least dividend, it had declared in the last two decades. The scheme's equity investment had increased to 64 per cent in the late 1990s from a mere 26 per cent in 1990. Both the primary and secondary segments of the capital market were in a depressed state, which reduced the chances of generating good returns to pay high dividends.

The government appointed a high-level committee under the chairmanship of Deepak Parekh, Chairman of HDFC, for restructuring UTI. The committee came up with 19 suggestions which included increasing the debt component in investments of the scheme, bringing the scheme under the purview of the SEBI, and the most prominent being to convert the US-64 into an NAV-driven scheme within a period of three years. UTI failed to tap the opportunity of converting this scheme into NAV driven during 1999–2000 when the capital market was bullish. The failure of UTI to implement the recommendations of Deepak Parekh Committee led to an eruption of another crisis in 2001.

UTI freezed the repurchase and sale of US-64 units in July 2001, shattering investors' trust. On the NSE, the fund was trading far below the repurchase price of ₹13.20 and dipped to a low of ₹9.60 within a week. The corporates had anticipated this well in advance and withdrew their funds before the crisis struck. To help out the small investors, the government provided ₹300 crore support to bridge the gap between NAV and the administered repurchase price of US-64 units.

The government set up a committee under the Chairmanship of former RBI Deputy Governor, S. S. Tarapore, to investigate the commercial aspects and investment decisions of the fund. The Tarapore Committee called for an inquiry into more than 19 investment decisions of the trust. It suggested creating three AMCs to handle growth funds, income funds, and Units Scheme-64, and introducing performance-linked management. According to the committee, the UTI Bank could hold 49 per cent of the capital of the three AMCs and this would, over time, enable greater private participation in UTI. It further recommended that only individual investors should be allowed to invest in US-64. Corporations and institutions should not be allowed to invest in US-64.

The Malegam Committee, which was formed by the board of trustees of UTI at the instance of the government, recommended a three-tier structure in line with the SEBI regulations comprising a sponsor, a trustee company, and an AMC. It suggested that the government should limit its stake through IDBI, SBI, and other government-backed financial institutions to 40 per cent and the rest 60 per cent could be offered to a sponsor or strategic partner. The trustee company should be a fully-owned subsidiary of sponsor company and shareholding of sponsor company in the AMC should be restricted to 40 per cent with the balance to be offered to public. The committee further recommended that the UTI Act should be repealed and replaced by a new enactment. The government must be completely distanced from UTI.

US-64 should be NAV based before restructuring of UTI is attempted. Provisions should be made for contingent liabilities, if any, arising out of the gap between the available assets of US-64 and guaranteed price to individual unit-holders owning upto 3,000 units.

In view of these recommendations, UTI took a decision to skip dividend for the first time in 2001–02 (Table 15.2) and to incorporate professionals on its board. The US-64 scheme moved to the NAV basis on January 1st, 2002. The US-64 NAV was hovering around ₹6 a unit which eroded the investors' confidence in the scheme.

In the year 2002, problems of liquidity and redemption pressures on the schemes surfaced again. Earlier it was US-64, the new problems related to 17 assured monthly income plans (MIPs) of UTI which had negative reserves. For instance, MIP 97 III had negative reserves of ₹260.1 crore, MIP 97IV had negative reserves of ₹296.8 crore, MIP 97 V had negative reserves of ₹170 crore, while MIP 98 had negative reserves of ₹296.8 crore. UTI met the redemption of the first MIP 97, which matured in June by dipping into its reserves. MIP 97 alone had a shortfall of ₹402 crore due to the large gap between its assured redemption price of ₹10 and the March 31st, 2002, NAV of ₹6.39. The development reserve fund which guarantees its assured return schemes was pegged at about ₹1,800 crore and the gap in its assured return schemes was in excess of ₹3,000 crore. Seeing the financial strain of UTI, the government provided it a partial guarantee for ₹1,000 crore. On the basis of this guarantee, UTI borrowed ₹1,500 crore from the State Bank of India (SBI) to meet its payment obligation on two monthly income plans.

The finance minister, Jaswant Singh, announced another bailout package for UTI. This package amounted to ₹14,561 crore and led to UTI bifurcating into UTI-I and UTI-II. On February 1st, 2003, the Unit Trust of India, the largest mutual fund was bifurcated into two—Specified Undertaking of the UTI (UTI-I) and UTI Mutual Fund (UTI-II). UTI-I took over all the assured return schemes, including US-64, while all the other schemes were taken up by UTI MF. The UTI Mutual Fund came under the full regulatory ambit of the SEBI. The government handed over one part, comprising the 43 net asset value based schemes (UTI-II) to a company floated by LIC, SBI, Punjab National Bank, and the Bank of Baroda. UTI-II started operations from February 1st, 2003. UTI-II has become a SEBI-compliant mutual fund with a three-tier structure, comprising a board of trustees, sponsors, and an asset management company with a paid-up capital of ₹10 crore. The four players have invested ₹2.5 crore each. The government will continue to run the ₹31,000 crore worth UTI-I, comprising the flagship scheme US-64 and other assured return schemes. The government has appointed one administrator and four advisors for the ailing UTI-I.

The government repealed the UTI Act through an ordinance. The government issued 10-year, tax-free bonds to banks and financial institutions to raise ₹10,000 crore to meet the shortfall in the NAV and declared the repurchase price of US-64. Those bonds carried a coupon rate of 7 to 7.5 per annum and could be redeemed in the last three years before maturity. Dividend reinvestment option under the income plan of US-64 was discontinued. Investors had the option either to encash their holdings at the declared, predetermined price or to convert the existing units with assured repurchase price into NAV-based prices or to invest in the tax-free bonds. The government assured a repurchase price of ₹12 per unit in respect of holding upto 5,000 units and ₹10 per unit in respect of holding above 5,000 units. Dividend income from

TABLE 15.2 Dividend History of US-64

Date	*Dividend (In %)*	*Rights/Bonus*
30.6.91	19.50	
30.6.92	25.00	Preference Offer@11.20 (July 1992)
30.6.93	26.00	2:5 Rights@12.80 (July 1993)
30.6.94	26.00	1.5 Rights@14.80 (September 1994)
30.6.95	26.00	1:10 Bonus Issue
30.6.96	20.00	
30.6.97	20.00	
30.6.98	20.00	
30.6.99	13.50	
30.6.00	13.75	
30.6.01	10.00	

Source: Capital Market, July 9–22, 2001.

Unit-64 was tax free and profit on the sale of US-64 units was exempted from capital gains tax and dividend received in UTI-I from its investments was passed on to the investors after administrative expenses.

This bailout package aimed at distancing UTI from the government and making it a market-driven entity. The Unit Trust of India announced a fresh package on 28th January 2003, for US-64 investors. This package gave an option to US-64 unit-holders to convert their units to 5-year, tax-free tradeable bonds that would effectively offer higher returns than other bonds of a similar tenure. Investors eligible to convert units to tax-free, tradeable bonds included those holding upto 5,000 units, these holding above 5,000 units (both classes have different assured returns from the government), and also those who bought the units from the secondary market. Units purchased between November 11, 2002 and January 22, 2003, continued to be traded and repurchased at the net asset value based price and were not offered these bonds. This package had not prompted investors to stay back even after the centre-sponsored guaranteed returns package expires on May 31, 2003.

UTI met the shortfall of its assured return schemes by taking loans from banks, offering the Development Reserve Fund as collateral and on the basis of the guarantee by the Government of India. The stock market rally in October 2003 enabled the US-64 scheme to wipe out its entire shortfall—the difference in unit capital and net asset value—estimated at nearly ₹4,500 crore in June 2002. UTI MF continued to hold the third largest market share even after the split till 2008.

The government has decided to liquidate the shares it holds in blue-chip Indian companies through the Specified Undertakings of UTI (UTI-I) and wind-up this entity.

GROWTH AND PERFORMANCE OF MUTUAL FUNDS IN INDIA

The Indian mutual fund industry has grown tremendously in the last decade. There are 41 mutual funds with average assets under management of around ₹19 lakh crore as on June 30, 2017. Assets under management (AUM) crossed ₹1,00,000 crore during the year 1999–2000 recording a growth rate of 65 per cent. Besides, vast majority of equity schemes out-performed the market. However, in the subsequent year, *i.e.*, 2000–01, AUM sharply declined by about 20 per cent to ₹90,587 crore due to extreme volatility in the market and depressed equity market conditions. The mutual fund industry witnessed such a sharp decline for the first time in the last two decades. There was a turnaround in the year 2001–02. The AUM grew by 11 per cent to ₹1,00,594 crore. During the year 2001–02 while there was an increase in AUM by around 11 per cent, UTI lost more than 11 per cent in AUM. It is evident that UTI is losing out to other private sector players. The AUM of private sector mutual funds rose by around 60 per cent during the year 2001–02. Assets under management grew by 22 per cent in 2003–04 and amounted to ₹1,49,554 crore in 2004–05.

The year 2003 was a high growth consolidation phase for mutual funds. The process was initiated by Franklin Templeton and HDFC mutual, which acquired Pioneer ITI and Zurich Mutual respectively.

The mutual fund industry was involved in a series of scams in the year 2003–04. These included running certain schemes such as portfolio management with a single investor, dividend stripping, declaring dividends in growth schemes, trading beyond regular hours at artificial NAVs to please corporate clients and transferring provident fund money into equities.

UTI MF completed one full year of existence on February 2004. In the year 2003–04, UTI Mutual Fund garnered over ₹3,000 crore in terms of assets. With ₹80,000 crore worth of AUM, it is now the fourth largest fund house in the country once again, despite the restructuring. UTI Mutual Fund was acquired by one of its sponsors, the State Bank of India.

The mutual fund industry is slowly catching the fancy of retail investors in India and the evidence is the growing IPO collections, rising equity markets and an increasing perception of mutual funds as a safe and convenient route to investing in the capital markets. Franklin India Flexi Cap fund collected a record ₹1,950 crore in its IPO that closed on February 9, 2005. This is the largest collection ever by an open-ended fund. JM Mutual Fund launched an equity and derivative fund to generate market neutral returns with the help of derivatives. This is the first time that such a fund is being launched in India. It is based on the concept of buying in the equity cash market and selling in the equity futures market and earning the cost of carry. The fact that a new and complicated concept has received an overwhelming response from investors shows the coming of age of the MF industry.

Foreign banks like HSBC, ABN Amro, and Deutsche have started their AMCs in India. Several global fund houses such as Already, and Aegon have shown interest in entering the Indian MF industry. This industry has been seeing consolidation as a number of global funds like Zurich, Alliance Capital, and Sun F&C have exited the country. Some funds have sold out because they could not compete in a fiercely competitive industry. Pioneer ITI, earlier Kothari Pioneer Mutual Fund, was sold out to Templeton India when it was arguably India's best fund house in terms of both performance and assets management. Zurich India when it was sold was amongst the best performing funds. It was sold by its Swiss parent as a part of its global restructuring strategy. Birla Sunlife Mutual Fund acquired Alliance Capital. Zurich's mutual fund business was acquired by HDFC mutual fund, UTI Mutual Fund bought IL & FS Mutual Fund and Principal India Mutual Fund took-over PNB's mutual fund and Sun F&C's operations.

In the year 2007–08, the largest number of new schemes-612 in all, were launched which was a record. The amount mobilized by the new schemes at over ₹1,60,733 crore was also a new record. The gross amount garnered was as high as ₹44.64 lakh crore—up by 130 per cent over the previous year. But the net accretion was only ₹1,53,801 crore. The net inflows and the AUM increased by 63 per cent and 55 per cent, respectively. The industry witnessed for the first time since 2000, a net outflow of funds for the year 2008–09 on account of the global financial turmoil. However, there was a sharp increase in the assets under management during 2012–13 with an improvement in the global financial markets scenario.

Investors preferred mutual funds as mutual funds offer tax benefits in the form of exemption on tax on both dividends and long-term capital gains. The assets under management rose sharply to ₹19 lakh crore in June, 2017 from ₹80,000 crore in March 2003. This significant rise was on account of the buoyant stock markets which enabled mutual funds to distribute higher dividends and raise NAVs. HDFC Asset Management Company Ltd. is the leader in the mutual fund industry going by the assets under its management as on June 30, 2017.

Mutual funds offered improved quality of service with AMFI making it mandatory for MF agents to undergo and pass its training programme for enabling them to explain the schemes to the customers properly. They introduced innovative and customer friendly products—Birla Mutual's cheque writing facility for the customer upto 75 per cent of the clear balance or ₹2 lakh, whichever is lower and IL&FS offer of improved liquidity by offering redemption facility on a T+0 (on the same trading day of application) basis while some other funds offered T+1 facility (on the next trading day of application).

As on March 31, 2017 while individuals subscribed 96.9 per cent of the total folios, their share in the total net assets was 45.7 per cent. On the other hand, corporates had a miniscule share of 1.2 per cent in the total number of folios, but their share in the total assets was a sizeable 48.6 per cent.

However, the private sector mutual funds manage 85 per cent of the net assets whereas public sector mutual funds manage only 15 per cent of the total net assets.

The mutual fund industry has been remarkably resilient over the last decade inspite of varying economic conditions, capital market scams, and increasing competition. A steep fall in stock prices on account of the global economic crisis and investor panic exerted redemption pressure on mutual funds during 2008–09. The net resources mobilized by private sector mutual funds and UTI turned negative. The stock market revival and availability of easy liquidity enabled mutual funds to garner larger resources. As on March 31, 2017, there were 2,281 mutual fund schemes of which 1,675 were income/debt oriented schemes, 484 were growth/equity oriented schemes, and 30 were balanced schemes. In addition, there were 63 ETFs, of which 12 were gold ETFs and 51 were non-gold ETFs. There were also 29 schemes operating as fund of funds which invested in overseas securities. In terms of the investment objectives, as on March 31, 2017, there were 829 open-ended schemes, 1,388 close-ended schemes and 64 interval schemes, but this number is a miniscule fraction of the 13,000 odd schemes offered by the mutual funds in the US. Moreover, in the US, there is more money in mutual funds than in bank deposits. In the US, individuals have 47 per cent of their household financial assets in mutual funds. The mutual fund in Brazil is over $600 bn and China over $300bn. AUM as a percentage of GDP in the US is 79 per cent, 39 per cent in Brazil, while in India only 8 per cent. Mutual funds in India have tapped only 2 per cent of the urban population and rural penetration is negligible. In urban areas, the mutual fund activity is more concentrated in the eight metros.

Debt funds are emerging as the most preferred investment option. Debt funds can have edge over banks as banks cannot offer attractive rates on deposits due to statutory reserves and priority sector lending. Debt funds are characterized as low-risk and high liquidity investments. Mutual funds worldwide have mobilized savings more through income funds than equity funds. This is so because mutual funds are able to offer diverse products based on the investors' risk return appetite. For example, there are liquid funds, government securities funds, and AAA rated bond funds. The government securities funds have no credit risk but interest rate risk. The liquid funds which are invested in the overnight call market carry a very low risk element compared to bond funds with both credit and interest rate risk. It

Takeovers in Indian MF Industry

Acquirer—Target

- Franklin Templeton MF—Pioneer ITI
- HDFC MF—Zurich India
- UTI MF—IL & FS MF
- Canbank MF—GIC MF
- Tata MF—Bank of India MF
- Birla Sunlife MF—Alliance MF
- Principal PNB MF—Sun F & C MF
- Sahara MF—First India MF
- IDFC—Stan C MF
- Religare Aegon—Lotus MF
- Reliance Capital Asset Management—Goldman Sachs India
- Edelweiss—JP Morgan
- Birla SunLife MF—ING MF
- HDFC MF—Morgan Stanley
- Kotak AMC—PineBridge India
- Pramerica MF—Deutsche Bank MF

is expected that returns from debt funds will increase in the future in view of the RBI's medium-term objective of reducing the cash reserve ratio (CRR) to 3 per cent.

In terms of AUM, the income/debt oriented schemes had the largest share of 61.2 per cent, followed by growth/equity oriented schemes with a share of 31.0 per cent. Debt schemes under income/debt oriented schemes registered inflows of ₹1,20,633 crore, followed by liquid/money market schemes at ₹95,826 crore and Non-ELSS schemes under growth/equity oriented schemes at ₹60,270 crore.

The business of mutual funds is profitable in India, with operating profits at 32 basis points (bps) as a percentage of average AUM. In the US market it is 18 bps and in UK it is 12bps. In developed markets, there are too many products for retail investors, fierce competition and thus, reduced fees. Moreover, the developed markets being highly efficient, the fund managers cannot deliver returns above market returns. Hence, they adopt a passive management strategy by offering low cost exchange traded funds. The Indian fund managers are active fund managers whereby each mutual fund manager builds up his own portfolio and have been in a position to beat the index, thereby delivering returns in excess of market returns. This industry has grown 47 per cent annually since 2003. As far as investments in the Indian securities market are concerned, with record breaking addition of more than 7.7 million folios, the mutual fund sector in India continued to grow significantly during 2016–17 with net fund mobilization to the tune of ₹3.43 trillion during the year and AUM touching a record level of ₹17.55 trillion as on March 31, 2017. Net investments by FPIs were ₹484 billion (US$ 7.18 billion) during the same period with net investments of ₹557 billion (US$8.75 billion) in equities and net sales of ₹73 billion (US$1.15 billion) in bonds. As of March 31, 2017, the total AUM of the sector stood at ₹17,54,619 crore. The AUM of the industry saw a remarkable year-on-year growth of 42.3 per cent in the year ending March, 2017. However, AUM to GDP (₹151.83 lakh crore at current prices) ratio of 11.6 per cent indicates a large untapped market potential and very low penetration vis-a-vis global and peer benchmarks. Thus the Indian mutual fund industry has a huge potential. There is an immense potential for growth and the main drivers of this growth will be the retail segment, expected to grow at 36–42 per cent annually on account of rising incomes and increasing demand for wealth management services, and innovative technological initiatives.

Mutual funds are expanding to various parts of the country with a large number of collection centres and franchise offices.

Conclusion

In India, mutual funds have a lot of potential to grow. Mutual fund companies have to create and market innovative products and frame distinct marketing strategies. Product innovation will be one of the key determinants to success. The mutual fund industry has to bring many innovative concepts such as high yield bond funds, principal protected funds, long short funds, arbitrate funds, dynamic funds, and precious metal funds. The penetration of mutual funds can be increased through investor education, providing investor-oriented value added services, and innovative distribution channels. Mutual funds have failed during the bearish market conditions. To sell successfully during the bear market, there is a need to educate investors about risk-adjusted return and total portfolio return to enable them to take an informed decision. Mutual funds need to develop a wide distribution network to increase its reach and tap investments from all corners and segments. Increased use of internet and development of alternative channels such as financial advisors can play a vital role in increasing the penetration of mutual funds. Mutual funds in order to increase their reach need to pump larger capital. They need to become more transparent and investor friendly.

The retail participation in mutual funds is still low on account of incorrect positioning of MF products, industry's focus on wholesale market, investor's preference for guaranteed return products and industry's inability to make in roads into smaller towns. There is a need to improve retail participation. Selling mutual funds requires competence in identifying and matching investors' needs. Moreover, they need to educate investors that mutual funds help to build capital, not to be become rich overnight. Mutual funds are dominant shareholders in portfolio companies. They can influence corporate governance by questioning the actions of company management, exercising voting rights, and using the proxy route to influence decisions by voting against the management. In India, mutual funds play a passive role in their portfolio companies and seldom exercise their voting rights. Mutual funds in India need to play a bigger role in corporate governance of public listed companies to restore faith and protect the interests of investors. Mutual funds have come a long way, but a lot more can be done.

CASE STUDY 1

Ajit is 30, newly married and a successful actor in the Indian film industry. Right from his struggling days, Ajit always saved a part of his income and invested in safe instruments like fixed deposits. However, during the internet boom in the late 90's and early 2000, he successfully invested in equities and mutual funds. Ajit thought that he was always well-diversified but when the internet stock bubble burst in 2002, Ajit lost a majority of his stock portfolio. A major mistake he made was that even though he was diversified, he invested only in tech-stocks. Ajit has always had a penchant for technology from his young age and thus he usually ended up buying tech stocks and funds. Currently, Ajit suffers from the snake-bite effect and thus he is not willing to participate in the equity market at all. Ajit, now misses the high returns that his portfolio had earned during the internet boom days. He has come to you to seek your suggestions to help his portfolio generate higher returns.

Q1. What do you think is Ajit's ability and willingness to take risk?
Q2. Will you recommend a stock only portfolio to Ajit or a mutual funds only portfolio for Ajit?
Q3. What kind of mutual funds will you recommend to Ajit?
Q4. Explain to Ajit how his new mutual fund portfolio achieves diversification. Why is this diversification important?
Q5. Recommend a portfolio mix for Ajit. Explain to Ajit why investments in equities improves the risk profile of the portfolio.

CASE STUDY 2

Amar Patel, aged 35, lives with his wife Mona, their 5 year old son Ankit and 10 year old daughter Mita. His parents also live with him in a flat in Puna. He had taken a housing loan on a floating interest rate three years ago to purchase the flat. He is a software engineer and he earns around ₹18,00,000 per annum. His net worth and cash flows are given below.

Net Worth

Assets:	
Savings account and fixed deposits	₹5,00,000
National savings certificates and bonds	₹2,00,000
Life insurance and Pension plans	₹100,00,000
Stocks (at cost)	₹30,00,000
House (flat)	₹25,00,000
Car	₹5,00,000
Liabilities	
Housing loan	₹20,00,000
Cash flows (Annual)	
Inflows:	
Salary income	₹18,00,000
Other income in the form of perks and bonus	₹2,00,000
Outflows:	
Household expenditure	₹3,00,000
Insurance premium	₹60,000
Taxes	₹5,00,000
Other lifestyle expenses	₹1,00,000
Travel and holidays	₹2,00,000
Home loan installment	₹2,40,000
Surplus	₹6,00,000

Amar has a term life insurance policy with a sum assured of ₹70 lakhs, in addition to a ₹20 lakh group life insurance cover from his employer. He also has a family health insurance policy worth ₹5,00,000. His parents are covered under a government medical scheme as his father retired as a government officer. In the current year, he took an additional ₹10 lakh cover for his entire family.

Amar is interested in stock markets and in his spare time discusses new IPOs, stock news, and market scenario. He has an above average risk appetite and is not afraid of risk. He has invested in stocks based on tips or advise received from friends and has around 30 stocks in his portfolio. The market was on a bull rally during the last four years and he booked profits on sale of some stocks. Suddenly, in January 2008, stock markets started sliding down and this freefall continued. He became frantic and looked for news and tips which would give some sign of hope. When he reviewed his portfolio, he found that around 50 per cent of his portfolio consisted of 'dud' shares of little value. He sold stocks in a panic in this falling market and as a result, he sold off good stocks too soon and held on to 'duds'. He loves investing in stocks and will continue to do so even if he incurs losses.

As he lacks the skills and time to monitor and adjust his portfolio, Amar seeks your help and advise. Please advise him on the following specific points:

1. Are Amar and his family adequately insured?
2. Is the asset allocation of Amar's portfolio optimal, considering his age and family position? If no what are the changes he should make?
3. Keeping in view Amar's risk appetite, how should he go about investing?