[Academic Script]

Mutual Funds (Part-1)

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Academic Script

Mutual Funds

(Part 1)

Topics: Types of Mutual Funds, Costs related to Mutual Funds, Benefits of Mutual Funds

Introduction:

In the last few years, numerous innovative offerings have emerged in the financial markets looking at the growing needs of consumers. The increase in education, knowledge, awareness and extensive use of social media has caused a shift in the minds of consumers so far their financial goals are concerned. They are ready to sacrifice certain present value to secure the uncertainties of future. The principle of having a diversified investment portfolio leads to maximizing returns and minimizing risk. Several securities are aimed at pooling little funds from small investors and managing them professionally over varied spread of investment options available in the market. Mutual fund, one such financial innovation, provides for a novel way of mobilizing savings from small investors and allowing them to participate in the equity and other securities of the industrial organizations with less risk. Hence it is the most suitable form of investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

Definition:

According to Association of Mutual Funds in India (AMFI), "A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. Anybody with an investible surplus of as little as a few thousand rupees can invest in Mutual Funds. These investors buy units of a particular mutual fund scheme that has a defined investment objective and strategy".

According to SEBI Regulations, 1996, "Mutual Fund means a fund established in the form of a trust to raise monies through the sale of units to public or a section of public under one or more schemes for investing in securities, in accordance with Regulations".

History:

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India. It was the initiative of the Government of India and Reserve Bank of India. The history can be broadly divided into four distinct phases.

First phase (1964-1987)

UTI worked under the regulatory and administrative control of RBI, in 1978, UTI was delinked from RBI and the Industrial Development Bank of India took the control of the same. At the end of 1988 UTI had Rs.6, 700 crores of assets under management.

Second Phase (1987-1993)

In this year, there was an entry of non-UTI funds. Public sector banks, LIC, GIC and SBI were the first to enter this market. By the end of this phase, the industry had assets under management of Rs.47, 004 crores.

Third Phase (1993-2003)

This phase marked the entry of private sector funds. Also in 1993, the first mutual Funds Regulations came into being, under which all mutual funds except UTI were to be registered and governed. Later many revisions were made in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. By the end of January 2003, there were 33 mutual funds with total assets of Rs.1, 21,805 crores.

Fourth Phase (February 2003 onwards)

In this month the UTI was bifurcated into two separate entities. One represented only the assets of US 64 scheme and was not under the purview of Mutual Funds Regulations. The second was sponsored by SBI, PNB, BOB and LIC. This was registered under the Mutual Funds Regulations. This phase also characterized the era of consolidation and growth

Role of SEBI:

The MF industry, by this time was grabbing attention of a large chunk of investors, hence SEBI came into action.

In the year 1992, the SEBI act was passed. The objectives of SEBI are;

- To protect the interest of investors in securities
- To promote the development of and to regulate the securities market
- To notify regulations for mutual funds
- To cover all the mutual funds promoted by various public, private or foreign players under the same set of regulations

So basically the MF industry is highly regulated and hence a safe zone for investment.

Also in 1995, a non-profit organization called the AMFI was established to promote healthy and ethical marketing practices in the Indian MF industry

Set up of Mutual Fund:

The mutual fund is set up in the form of trust, which has a sponsor, Trustees, Asset Management Company (AMC) and Custodian. The role and functions of various parties to Mutual funds are reflected in the following table

Sponsor	• Acts as a promoter of the company • Establishes the mutual fund • Gets it registered with SEBI • Forms a Trust and appoints Board of Trustees • Contribute at least 40% of the net worth of the AMC
Trustees	• To hold the property on behalf of unit holders • Appoint AMC and ensure that all the activities are under the SEBI Regulations • Appoint the custodian of the fund • Accountable for funds and property of respective schemes
Asset Management Company (AMC)	• Floatation of various schemes according to investor

	requirements • Management of mutual funds according to SEBI Regulations • To decide on the fees to be charged in order to carry out asset management activities
Custodian	• Holds the funds securities in safe keeping • Settles securities transactions of the fund • Collects interests and dividends paid on securities • Records information on stock splits and other corporate actions
Distributors / Agents	• Sells units on behalf of the fund • Comprises of banks, non-banking financial companies and other distribution companies, individuals
Banker	• Facilitates the financial transactions • Provides remittance facilities
Registrars and Transfer Agent	• Maintains records of unit holders' accounts and transactions • Receives funds from investing public and allot units • Disburses the funds to the unit holders • Handles communication with the unit holders • Provides unit holder transactions services

Classification of Mutual Fund Schemes:

A. Open ended Schemes:

- Do not have a fixed maturity period
- Allows investors to sell or buy at any point in time at a price linked to Net Asset Value (NAV)

- Available for subscription and repurchase on continuous basis
- Liquidity is the key advantage

1. Debt/income Fund:
   - To provide regular and steady income to investors
   - To invest in debt instruments issued by governments, private sector companies, banks and financial institutions
   - Less risky
   - Gilt funds are such funds that invest only in government securities. So no default risk involved

2. Money market/liquid Fund:
   - To park surplus funds in short term instruments and avail liquidity, preservation of capital and moderate income
   - Investment in instruments like treasury bills, certificate of deposits, commercial papers, government securities etc.
   - Less fluctuations in returns as compared to other securities

3. Equity/growth Fund:
   - Investment in equity shares of various companies
   - To provide capital appreciation as well as high level of current income through dividends

   3.1 Index schemes:
   - Replicates the portfolio of benchmark indices such as BSE (Sensex), NSE (Nifty) etc.
   - NAV of such schemes would fluctuate in accordance with the index, though not exactly by the same percentage due to some factors known as *'tracking error'*. It is the difference between a portfolio's returns and the benchmark or index it was meant to beat.

3.2 Sectoral schemes:

- Investment in only one industry or sector of funds such as information technology, automobile, pharmaceuticals etc.
- Higher returns but riskier than diversified funds

3.3 Tax Saving:

- Offer tax rebate to the investors
- E.g. Equity Linked Savings Scheme, pension schemes etc.

4. Balanced Funds:

- To provide growth and regular income as such schemes invest both in equities and fixed income securities in the proportion indicated in the offer documents
- Ideal for cautiously aggressive investors

B. Close ended schemes:

- Have a fixed maturity period (5-15 years)
- Makes a one-time sale of a fixed number of units during the initial offer period
- Open for subscription only during launch period
- Discloses NAV on weekly basis
- Some schemes provide an exit route to investors by giving an option of selling back the units to mutual funds through periodic repurchase at NAV related prices through listing on stock exchanges

1. Capital Protection :
   - To safeguard the principal amount while trying to deliver reasonable returns
   - To invest in high quality fixed income securities with marginal exposure to equities and mature along with the maturity period of the scheme
2. Fixed Maturity Plans (FMPs):

- Investment in debt instruments which mature in line with the maturity of the scheme, thereby earning through the interest component of the securities in the portfolio
- Passively managed so low expenses charged

C. Interval Schemes:

- Combination of open and closed ended schemes
- Allows investors to trade units at predefined intervals

D. Fund of Fund Schemes:

- Invests in other mutual funds
- Reduces risk by diversification
- Tax effective
- Costs of funds are higher

Costs of investing in a Mutual Fund:

There are four types of costs;

1. ***Initial issue expenses***: It includes items such as brokerage, commission, marketing and advertising expenses, and printing and distribution costs. A proposal to disallow these expenses is under consideration.
2. ***Entry Load***: It includes the load imposed when the units are purchased. It is added to the NAV at the time of allotment. Schemes that have an entry load are called load schemes and those which have no entry load are called no load funds.
3. ***Exit load***: It includes the load imposed when the units are sold back to the mutual fund. Its aim is to deter investors from withdrawing. It varies from 0 to 3 percent.
4. ***Annual recurring expenses***: It includes the investment management and advisory fees charged by the AMC and operating expenses like marketing and selling expenses. It is 1.25% of net assets up to Rs.100 crores and 1% above Rs.100 crores.

The above costs are visible but there is a large invisible cost which is overlooked and that is ***portfolio transaction cost***. When a mutual fund buys or sells securities it incurs commissions as well as market impact costs. They depend on the rate of portfolio turnover and the degree of liquidity and marketability of securities included in the portfolio. Hence the investors need to be aware of the potential impact on investment returns.

Criteria to choose a fund:

- ***Track record of the fund manager***: The fund manager should have a good track record at efficient fund management to create confidence in the mind of the investor.
- ***Quality of the portfolio (consideration of risk and return):*** Mutual fund schemes are periodically evaluated by independent organizations like Economic Times, CRISIL (Credit Rating and Information Services of India Limited), etc. who give ratings or grades to the quality of the portfolio and thus guide various stakeholders in taking decisions.
- ***Number of retail investors and average holding size of retail investors***: Small funds could be in trouble if the investors quit the same for some or the other market factor.
- ***Size of the funds***: Bigger funds seem to have better access to opportunities as compared to smaller funds.
- ***Weighted average maturity***: Longer maturities hedge against downward movements in interest rates but it could lose out on short term upswings in interest rates. Short maturities protect against rising interest rates.
- ***Dividend frequency***: The investors looking for regular returns would prefer tax free dividends but it could hinder capital growth as well.
- ***Offer Document (OD) and Key Information Memorandum (KIM)*****:** This is the most important source of information for investors. The KIM is the abridged version of the OD. It is to be compulsorily made available along with the application form.

- It contains the preliminary information of the fund and the scheme, details of the scheme, investor rights and information on income and expenses of existing schemes. The main attributes of the scheme are its type, objectives, investment pattern, fees and expenses, liquidity conditions, accounting and valuation, and investment restrictions.

  The AMC prepares the OD and KIM and is responsible for the information contained in it and the trustees approve the contents of the OD and KIM.

Tax Aspects of Mutual fund investment:

a. At fund level:

- The entire income of a mutual fund registered with SEBI is exempt from income tax in accordance with the provision of Section 10 (23D) of the Income Tax Act, 1961.
- It is liable to pay securities transaction tax on its purchases and sales of equity shares, units of equity oriented funds and derivatives as well as dividend distribution tax.

b. At unit holders' level:

- The dividend received from mutual funds is tax exempt in the hands of the unit holders.
- Long term capital gains arising from the sale of units of equity oriented funds are exempt from income tax provided the securities transaction tax is charged on sale by the mutual fund.
- Short term capital gains from the transfer of units of an equity oriented scheme are taxed at the rate of 15% plus applicable surcharge and cess, provided the securities transaction tax is charged on sale by the mutual fund.
- Long term or short gains from sale of units of mutual fund schemes, other than equity oriented schemes are taxed in the hands of unit holders.

Benefits of MF investments:

1. **Professional management**

The funds are managed by the skilled and professionally experienced managers with back up of a research team.

2. **Diversification**

MF offers diversification to reduce risk.

3. **Convenient administration**

Services are offered in de-mat form and hence time and delays are taken care of.

4. **Low cost of management**

The costs cannot exceed the prescribed limits of SEBI.

5. **Liquidity**

In case of open ended schemes, liquidity is provided by direct sale/repurchase by MF and in case of closed ended schemes it is provided by listing the same on a stock exchange.

6. **Transparency**

NAVs are calculated on daily basis. Performance reports are provided half yearly and hence they are transparent.

7. **Highly regulated**

All the schemes come under the strict purview of SEBI Regulations thus protecting investor interests.

8. **Small investments**

An investor with a few thousand rupees can invest in MFs.

9. **Tax advantages**

MFs are tax exempt entities. No taxes are paid in dividends and interest incomes as well as long term capital gains. The dividends distributed by MFs are also tax free for recipients.

10. **Other benefits**

The investors can easily switch over from one scheme to another. Also regular withdrawal and systematic investment plans are available to investors.

Summary:

This session explains the evolution of mutual funds as a newer and safer avenue of investment for cautious investors. It is necessary to know for a student as to how the fund managers operate and deal with public money so there is some light thrown on the role and functions of the various parties to mutual funds. The classification of mutual funds elucidates the need of varied and hybrid products introduced in the market to cater to all types of investors. Also the growth in the overall investment in this sector as well as the benefits attached to it explains its growing popularity. As a rule 'Don't put all your eggs in one basket', it also explains the costs involved and the limitations of the said tool for investment.