3 HISTORY AND DEVELOPMENT OF MUTUAL FUND INDUSTRY IN INDIA

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Abstract

The formation of Unit Trust of India marked the evolution of the Indian mutual fund industry in the year 1963. The primary objective at that time was to attract the small investors and it was made possible through the collective efforts of the Government of India and the Reserve Bank of India. Unit Trust of India enjoyed complete monopoly when it was established in the year 1963 by an act of Parliament. Now Mutual fund industry in India has 40 players. The number of public sector players has reduced from 11 to 5. The public sector has gradually receded into the background, passing on a large chunk of market share to private sector players.

The Association of Mutual fund in India (AMFI) is the industry body set up to facilitate the growth of the Indian mutual fund industry. It plays a pro-active role in identifying steps that need to be taken to protect investors and promote mutual fund sector. It is noteworthy that AMFI is not a self-regulatory organization (SRO) and its recommendations are not binding on the industry participants. By its very nature, AMFI has an advisor's or a counselor's role in the mutual fund industry. Its recommendations become mandatory if and only if the Securities and Exchange Board of India (SEBI) incorporates them into the regulatory frame work it stipulates for mutual funds.

The global meltdown had various repercussions, ranging from a galloping inflation and slowdown in industrial production to an uncertain political environment, leading to the equity and debt markets being weathered down. The volatility in markets and the uncertainties in global and local political environment led to dent in the capital market performance, challenging fund houses to deliver consistently, irrespective of the unfolding adverse situations. The mutual fund industry was actually able to buck the trend and show an increase in asset under management. On the positive note, the financial turmoil has helped highlight the benefits of investing in mutual funds vis-a-vis directly investing in stocks.

In this background, this article analyzes the history and development of the mutual fund industry in India.

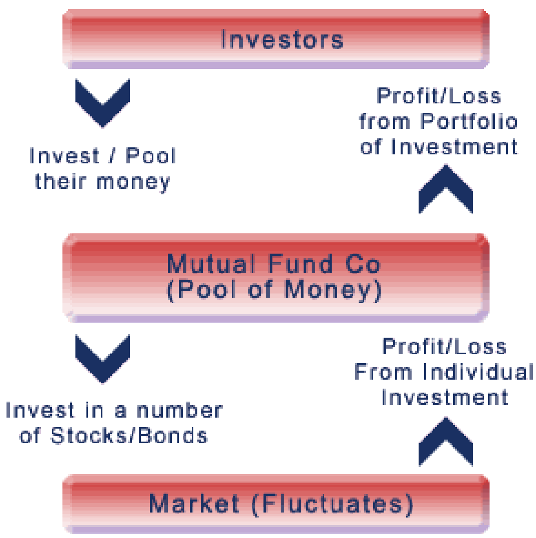
Introduction

A mutual fund is just the connecting bridge or a financial intermediary that allows group of investors to pool their money together with a predetermined investment objective. The mutual fund will have a fund manager who is responsible for investing the gathered money into specific securities (Stocks or bonds) when you invest in a mutual fund, you are buying units or portion of the mutual fund and thus on investing becomes a shareholder or a unit holder of the fund.

Mutual funds are considered as one of the best available investments as compared to others. They are very cost efficient and also easy to invest in. Thus by pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading cost than if they tried to do it at their own. But the biggest advantage to mutual fund is diversification, by minimizing risk and maximizing return.

Thus a mutual fund is the most suitable 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.

The flowchart describes broadly the working of a mutual fund.



Advantages of Mutual Funds

1. Professional Management

Active portfolio management requires not only sound investment sense, but also considerable time and skill. By investing in mutual fund, an investor does not have to track the prospects and potential of the companies in the mutual fund portfolio. This is already being done by skilled research professional appointed by the mutual fund houses, professionals whose job it is to continuously research and monitor these companies.

2. Diversification

For an investor the mutual fund is the nuclear weapon to fight against risk. It simply means that one must spread their investment across different securities stock, bonds, money market instruments, real estate, fixed deposits etc. and different sectors auto textile, information technology etc. This kind of a diversification may add to the stability of return. For Example: During one period of time equities might underperform but bonds and money market instruments might to well enough to offset the effect of a slump in the equity market similarly the information technology sector might be fairly poor but the auto and textile sector might do well and may protect the investor's principle investment as well as meet ones return objectives.

3. Low Entry Level

An investor can invest in mutual funds depending upon the investment objective of the scheme. An investor can buy in to a portfolio of equities, which would otherwise be extremely expensive.

4. Liquidity

Mutual funds offer liquidity while investing. In case of an open-ended fund, it is completely liquid and can be redeemed at their Net Asset Value (NAV) related price on any working day.

5. Transparency

An investor will always have access to up-to-date information on the value of their investment in additional to the complete portfolio of investments, the proportion allocated to different assets and the fund manager's investment strategy. All mutual funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interest of investors. The operations of mutual funds are regularly monitored by SEBI.

6. Variety

Mutual funds offer a variety of schemes. This variety is beneficial in two ways. First, it offers different types of schemes to investors with different needs and risk appetites, secondly, it offers an opportunity to an investor to invest sums across a variety of schemes, both debt and equity. For Example: An investor can invest his money in a growth fund equity scheme and income fund debt scheme depending on his risk appetite and thus create a balanced portfolio easily.

7. Regulations

Securities Exchange Board of India (SEBI) the mutual funds regulators has clearly defined rules, which govern mutual funds. These rules relates to the formations, administration and management of mutual funds and also prescribe disclosure and accounting requirements such a high level of regulation seeks to protect the interest of investors.

Disadvantages of Mutual Fund

1. No Guarantees

No investment is risk free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. Investors encounter fewer risks when they invest in mutual funds than when they buy and sell stocks on their own. However, anyone who invests through a mutual fund runs the risk of losing money.

2. Fees And Commissions

All funds charge administrative fees to cover their day-to-day expenses. Some funds also charge sales commissions or "loads" to compensate brokers, financial consultants, or financial planners.

3. Taxes

During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If the fund makes a profit on its sales, the investor will pay taxes on the income received.

4. Management Risk

When one invests in a mutual fund, one has to depend on the fund's manager to make the right decisions regarding the fund's portfolio. If the manager does not perform as well as one had hoped, one might not make as much money on their investment as one expected.

Structure of the Mutual Fund Industry in India

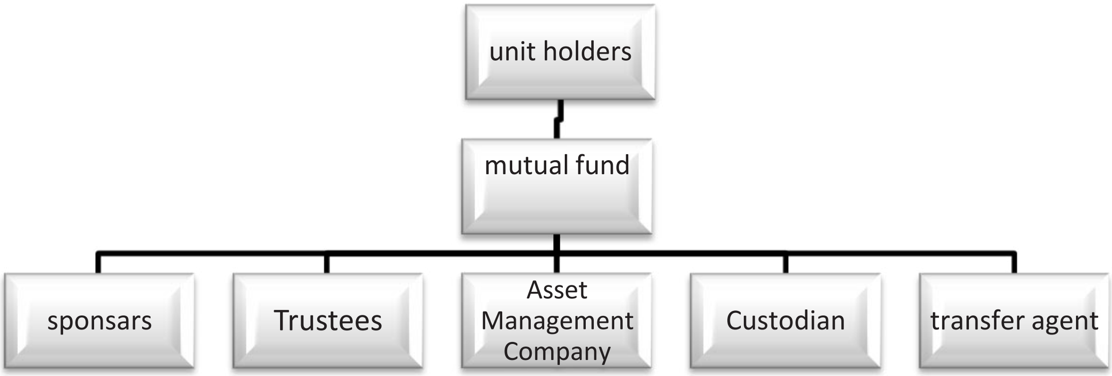
Mutual fund industry in India has 40 players. The number of public sector players has reduced from 11 to 5. The public sector has gradually receded into the background, passing on a large chunk of market share to private sector players.

The Association of Mutual fund in India (AMFI) is the industry body set up to facilitate the growth of the Indian mutual fund industry. It plays a pro-active role in identifying steps that need to be taken to protect investors and promote mutual fund sector. It is noteworthy that AMFI is not a Self-Regulatory Organization (SRO) and its recommendations are not binding on the industry participants. Its recommendations become mandatory if and only if the Securities and Exchange Board of India (SEBI) incorporates them into the regulatory frame work it stipulates for mutual funds.

The Indian Mutual Fund Industry follows the following structure:

1. Sponsors

They are the individuals who think of starting a mutual fund. The sponsor approach SEBI, the market regulator and also the regulator for mutual funds. Not everyone can start a mutual fund. SEBI will grant a permission to start a mutual



fund only to a person of integrity, with significant experience in the financial sector and a certain minimum net worth. These are just some of the factors that comes into play.

Trustees

Once SEBI is satisfied with the credentials and eligibility of the proposed sponsors, the sponsors then establish a trust under the Indian Trust Act 1882. The Trust has no legal identity in India and thus cannot enter into contract. Hence the trustees are the individuals authorized to act on behalf of trust. Contracts are entered into the name of trustees once the trust is created, it is registered with SEBI, after which point, this trust is known as Mutual Fund.

1. Asset Management Company(AMC)

The trustees appoint the AMC, which is established as a legal entity to manage the investors (Unit Holders) money. In return for this, the AMC is paid a fee for the service provided. This fee is to be borne by the investors and is deducted from the money collected from them. The AMC has to be approved by SEBI and functions under the supervision of its BOD, and also under the direction of the trustees and regulatory framework established by SEBI. It is an AMC which in the name of trust, that floats new schemes and manages these schemes by buying and selling securities.

2. Custodian

The Custodian maintains the custody of securities in which the scheme invests. It also keeps a tab on corporate actions such as rights, bonus and dividends declared by the companies in which the fund has invested. The custodian is appointed by the Board of Trustee. The Custodian also participates in a clearing and settlement system through approved depository companies on behalf of MFs, in case of dematerialized securities.

3. Transfer agent

Registrar and transfer agents maintain the investors (unit holders) records, reducing the burden on the AMCs. So in the diagram, one can see the sponsor, the trustees, the AMC, the mutual fund, its transfer agents and the custodian, and last but not the least the unit holders. All of these industry participants function within the regulations laid down by the SEBI.

History of Mutual Fund Industry

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

First Phase – 1964-87

Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6, 700 crores of assets under management.

Second Phase – 1987-1993 (Entry of Public Sector Funds)

The year 1987 marked the entry of non-UTI, public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). SBI Mutual Fund was the first non- UTI Mutual Fund established in June 1987 followed by Can bank Mutual Fund (Dec 1987), Punjab National Bank Mutual Fund (Aug 1989), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 1992). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990. At the end of 1993, the mutual fund industry had assets under management of Rs.47, 004 crores.

Third Phase – 1993-2003 (Entry of Private Sector Funds)

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1, 21,805 crores. The Unit Trust of India with Rs.44, 541 crores of assets under management was way ahead of other mutual funds.

Fourth Phase – since February 2003

During February 2003, following the repeal of the Unit Trust of India Act 1963 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs.29, 835 crores (as at the end of January 2003), representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76, 000 crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth.

The industry has also witnessed several mergers and acquisitions recently, examples of which are acquisition of schemes of Alliance Mutual Fund by Birla Sun Life, Sun F&C Mutual Fund and PNB Mutual Fund by Principal Mutual Fund. Simultaneously, more international mutual fund players have entered India like Fidelity, Franklin Templeton Mutual Fund etc. There were 29 funds as at the end of March 2006. This is a continuing phase of growth of the industry through consolidation and entry of new international and private sector players.

Schemes

The AMC offers various (schemes/funds), which are structured in a manner to benefit and suit the requirement of investors. Every scheme has a portfolio statement, revenue account and balance sheet.

Basic	Type of funds/schemes					
	1	2	3	4	5	6
Tenor	Open ended	Close Ended	-	-	-	-
Asset class	Equity	Debt/Income	Hybrid	Real Estate	-	-
Investment Philosophy	Diversified Equity	Sector	Index Funds	Exchange Traded Funds (ETFs)	Fund of Funds (FOF)	Fixed Maturity Plan (FMPs)
Geographic Regions	Country/ Regions	OFF shares	-	-	-	-

Tenor:

Tenor refers to the time mutual funds can be classified on the bases of time as under;

1. Open Ended Funds

These funds are available for subscription throughout the year. These funds do not have a fixed maturity period. Investors have the flexibility to buy or sell any part of their investment at any time, at the prevailing price (Net Asset Value – NAV) at that time.

2. Close Ended Funds

These funds are open for subscription only during a specified period with a fixed corpus, when the period terminates, investors can redeem their units at the prevailing NAV.

Assets Classes

1. Equity Funds :

These funds invest in shares. These funds may invest money in growth stocks, momentum stocks, value stocks or income stocks depending on the investment objective of the fund.

2. Debt Funds or Income Funds :

These funds invest money in bonds and money market instruments. These funds may invest into long-term and/or short-term maturity bonds.

3. Hybrid Funds

These funds invest in a mix of both equity and debt. In order to retain their equity status for tax purposes they generally invest at least 65% of their assets in equities and roughly 35% in debt instruments, falling which they will be classified as debt oriented schemes and be taxed accordingly.

4. Real Asset Funds

These funds invest in physical assets such as gold, silver, oil, commodities and real estate.

Investment Philosophy

1. Diversified Equity Fund

   These funds diversify the equity component of their Asset under Management (AUM), across various sectors. Such funds avoid investing more of their assets towards a particular sector such as Gas and oil, construction etc. they use the diversification strategy to reduce the overall portfolio risk.

2. Sector Funds

   These funds invest predominantly in a specific sector. For instance, a banking fund will invest only in banking stock. Generally, such funds invest 65% of their total assets in a respective sector.

3. Index Fund

   These funds seek to have a position which replicates the index, say BSE Sensex or NSE Nifty. They maintain an investment portfolio that replicates the composition of the chosen index, thus following a passive style of investing.

4. Exchange Traded Funds

   These funds are open ended funds which are traded on the exchange (BSE/NSE). These funds are benchmarked against the stock exchange index. For example: funds traded on the NSE are benchmarked against the Nifty. In exchange traded funds (since they are traded on exchange) the price keeps on changing during the trading hours of the exchange.

- Fund of Funds (FOFS)

  These funds invest their money in other funds of the same mutual fund house or other mutual fund houses. They are not allowed to invest in any other FOF and they are not entitled to invest their assets other than in mutual fund schemes/fund requires liquidity to meet its redemption requirements, as disclosed in the offer document of the FIF schemes.

- Fixed Maturity Plan (FMP)

  These funds are basically income/debt schemes like bonds, debentures and money market instruments. They give a fixed return over a period of time. FMPs are similar to close ended schemes which are open only for a fixed period of time during the initial offer. However, unlike close ended schemes where your money is locked for a particular period, FMPs give you an option to exit. Remember though, that this is subject to an exit load as per the funds regulations, FMPs, if listed on the exchange, provides the investor an opportunity to liquidate the units at the prevailing price on the exchange.

Geographic Region

- Country or Region Fund:

  These funds invest in securities(equity and/debt) of a specific country or region with an underlying belief that the chosen country or region is expected to deliver superior performance, which in turn will be favorable for the securities of that country. The returns on country fund are affected not only by the performance of the market where they are invested, but also by changes in the currency exchange rate.

- Off Shore Fund

  These funds mobilize money from investors for the purpose of investment within as well as outside their home country.

Conclusion

The global meltdown had various repercussions, ranging from a galloping inflation and slowdown in industrial production to an uncertain political environment, leading to the equity and debt markets being weathered down. The volatility in markets and the uncertainties in global and local political environment have led to a dent in the capital market performance, challenging fund houses to deliver consistently, irrespective of the unfolding adverse situations. The mutual fund industry was actually able to buck the trend and show an increase in asset under management. On the positive note, the financial turmoil has helped highlight the benefits of investing in mutual funds vis-a-vis directly investing in stocks.

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