MUTUAL FUNDS IN INDIA

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Chapter 1

Mutual Fund
Concepts, Organization & Advantages

> *"Mutual Funds are among the hottest favourites with all types of investors. In fact, mutual funds represent the hands-off approach to entering the equity market. There are a wide variety of mutual funds that are viable investment avenues to meet a wide variety of financial goals. This section explains the various aspects of Mutual Funds."*
> ***Tushar kanti Ghosh****

A mutual fund, as defined in the regulations is 'a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments'. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them.

From the first part of this definition it becomes clear that a mutual fund is a collection of investments. It is a pool of money, the combined contributions of a number of individuals.

While the mutual fund is a collection of money, it requires some person or body to mobilise and manage these assets. This entity is usually an organisation, aptly known as an asset management company (AMC). The AMC is thus the physical entity, the organisation, and the company, which generates the collective investment from the public with a view to invest in securities and generates returns. By virtue of its mobilisation function, the AMC has offices or branches in a number of cities. These branches collect money from investors and are one of the visible faces of the mutual fund. As this money has to be invested and managed, the AMC has an investment team. The head of this team, the Fund Manager or the Chief Investment Officer is another visible face of the mutual fund. The fund manager is at the head of the decision making process which takes strategic and the tactical decisions on where to invest.

The mutual fund is thus, best represented by the AMC, as it is the actual organisation, which collects and manages the mutual investments. But the AMC is not the only part of the mutual fund game. As the fund is established as a trust, there exist the trustees of the mutual fund. The "trustee" refers to a body of individuals or a company who hold the property of the mutual fund in trust for the benefit of the unit holders.

Trustees are thus a board of trustees or a trustee company who have reposed faith/confidence to regulate the functioning of the AMC. They hold the assets of the mutual fund in trust

*The author currently works with the Outlook Group for the benefit of unit holders in accordance with these regulations and the provisions of the trust deed. Along with being accountable for the funds and property of the respective schemes they are also the custodians of the unit holder's assets. The trustee's responsibilities are not limited to a single function. Besides serving as the 'in house' regulators of the AMC, they link the AMC with the mutual fund through an investment management agreement. Though this, the trustees appoint the AMC as the managers of assets of the unit holders. Their link with both the AMC and the 'mutual fund' thus places them at the apex of the three- tier structure, which constitutes the Indian Mutual Fund Industry. The trustees also serve to link the functioning of the AMC to that of the market regulator - SEBI

Through regular reports to SEBI, the trustees provide inputs on the functioning of the mutual fund. Any shortcomings in the functioning of the AMC are meant to be corrected and reported. The trustees thus serve as the first level regulators. This structure ensures that the AMC, which administers the assets is kept at a distance from the pool of collected investments. The trustees, while not managing the assets hold them in the name of the investor. As a body, which is separate from the asset managers, the trustees are tasked with ensuring that the funds collected, are employed for the purpose stated. Through this structure a series of checks and balances are created, which is internal to the mutual fund.

Thus, 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 flow chart below describes broadly the working of a mutual fund:

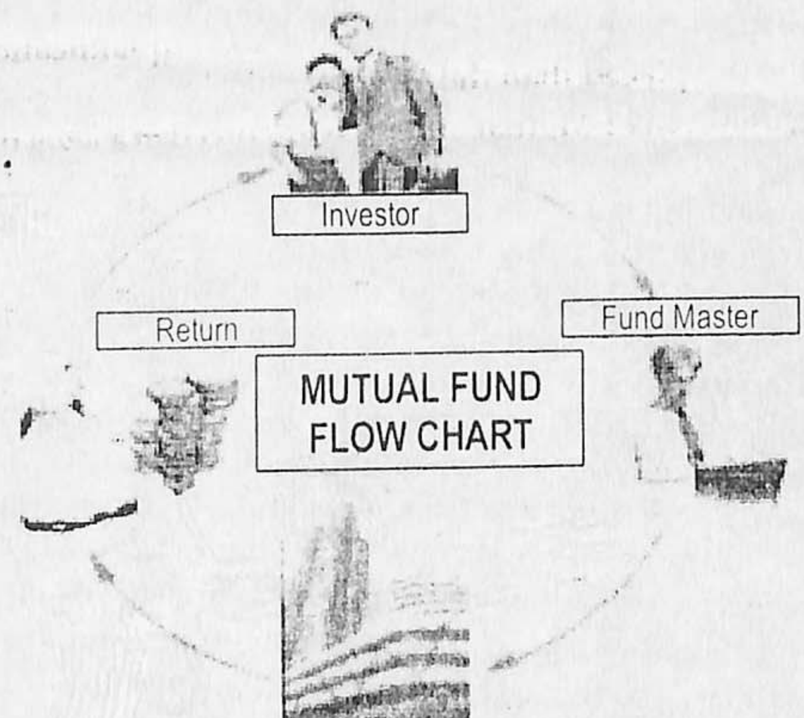

Fig 1.1. Mutual Fund Operation Flow Chart
Source: www.5paise.com

ORGANISATION OF A MUTUAL FUND

As explained above there are many entities involved and the diagram below illustrates the organisational set up of a mutual fund:

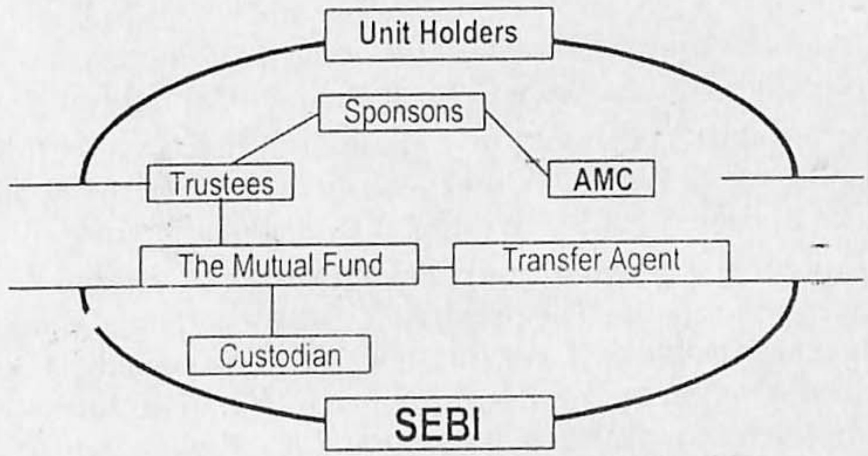

Fig. 1.2 Organisation of a Mutual Fund.

Source: www.americanfunds.com

To be sure, mutual funds are a great way to invest in equities, but there are some reasons for the same, more fundamental than just soaring investor interest. For retail investors, who have money, but don't have time and expertise, mutual funds are perhaps the only way to invest in stock markets. Also the mutual fund route is certainly a lot more 'surer' and less risky than investing directly in stocks.

The advantages of investing in a Mutual Fund are :

1. **Power of knowledge :** Fund managers are professionals who track the market on an on-going basis. With their mix of professional qualification and market knowledge, they are better placed than the average investor to understand the markets.
2. **Offering Solutions :** Mutual funds have evolved at a level that gives investors solutions for retirement planning, planning for child's education/marriage, and even buying a house to outline a few goals. There are mutual funds tailor-made to help investors achieve these financial goals.
3. **Diversification :** Since a Mutual Fund scheme invests in number of stocks and/or debentures, the associated risks are greatly reduced.
4. **Low Costs :** When compared to direct investments in the capital market, Mutual Funds cost less. This is due to savings in brokerage costs, demat costs, depository costs etc.
5. **Liquidity :** Investments in Mutual Funds are completely liquid and can be redeemed at their Net Assets Value-related price on any working day.
6. **Transparency :** You will always have access to up-to-date information on the value of your investment in addition to the complete portfolio of investments, the proportion allocated to different assets and the fund manager's investment strategy.
7. **Flexibility :** Through features such as Systematic Investment Plans, Systematic Withdrawal Plans and Dividend Investment Plans, you can systematically invest or withdraw funds according to your needs and convenience.
8. **Tax neutral :** Even in the mind of the finance minister, there is no difference between stocks and equity-oriented funds, at least not where tax benefits are concerned. Long-term capital gains on both stocks and equity-oriented funds are tax-free. Likewise, short-term gains on both are taxed at 10% plus surcharge and education cess. Also

dividends from both are tax-free in the hands of investors. So investors do not stand to lose out on any tax benefit by investing in equity funds vis-à-vis stocks.

9. **Affordability** : Investors individually may lack sufficient funds to invest in high-grade stocks. A mutual fund because of its large corpus allows even a small investor to take the benefit of its investment strategy.

10. **Structure** : Mutual funds have a solid 3-tier structure in place that works in the investor's interest. The promoter/sponsor sets up a mutual fund, but does not exercise direct control over it. For this, it sets up a board of trustees. The trustees in turn set up an asset management company (AMC). The latter looks after the day-to-day administration, sales, marketing and fund management. This way there is very little link between the sponsor/promoter and the mutual fund schemes. This ensures that mutual fund schemes are managed professionally without any 'interference'.

11. **SEBI regulated market** : All Mutual Funds are registered with SEBI and function within the provisions and regulations that protect the interests of investors. AMFI is the supervisory body of the Mutual Funds industry

Investors of all categories could choose to invest on their own in multiple options but opt for mutual funds for the sole reason that all benefits come in a package. Let us see how.

An investor normally prioritizes his investment needs before undertaking an investment. So different goals will be allocated different proportions of the total disposable amount. Investments for specific goals normally find their way into the debt market as risk reduction is of prime importance. Suitable products for Debt market are: Bank/Company Fixed Deposits and Debt based funds. This is the area for the risk-averse investors and here; mutual funds are generally the best option. The reasons are not difficult to see.

Table 1.1. Banks v/s Mutual Funds

	Company Fixed Deposits	*BANKS*	*MUTUAL FUNDS*
Returns	Fixed	Low	Better
Risk	High (Credit rating could change while investment is locked inside, defaults are not uncommon)	Low	Moderate
Investment options	Less	Less	More
Network	Low penetration	High penetration	Low but improving
Liquidity	At a cost	At a cost	Better
Quality of assets	Not transparent	Not transparent	Transparent
Interest calculation	Fixed	Minimum balance between 10th. & 30th. Of every month	Everyday
Guarantee	None	Maximum Rs.1 lakh on deposits	None

Source : Complied from various sources.

Moving up in the risk spectrum next come the risk takers. Risk takers by their very nature, would not be averse to investing in high-risk avenues. Capital markets find their fancy more often than not, because they have historically generated better returns than any other avenue, provided, the money was judiciously invested. Though the risk associated is generally on the higher side of the spectrum, the return-potential compensates for the risk attached.

Capital markets interest people, albeit not all for there are several problems associated. First issue is that of expertise. While investing directly into capital market one has to be analytical enough to judge the valuation of the stock and understand the complex undertones of the stock. One needs to judge the right valuation for exiting the stock too. It is very difficult for a small investor to keep track of the movements of the market. Entrusting the job to experts, who watch the trends of the market and analyze the valuations of the stocks will solve this problem for an investor. Mutual funds specialize in identification of stocks through dedicated experts in the field and this enables them to pick stocks at the right moment. Sector funds provide an edge and generate good returns if the particular sector is doing well.

Next problem is that of funds/money. A single person can't invest in multiple high-priced stocks for the sole reason that his pockets are not likely to be deep enough. This limits him from diversifying his portfolio as well as benefiting from multiple investments. Here again, investing through MF route enables an investor to invest in many good stocks and reap benefits even through a small investment. This not only diversifies the portfolio and helps in generating returns from a number of sectors but reduces the risk as well.

Besides this, if the objective was to save taxes, the industry offers equity linked savings schemes as well. Equity-based funds, they can take long-term call on stocks and market conditions without having to worry about redemption pressure as the money is locked in for three years and provide good returns. Some of the ELSS have been exceptional performers in past and cater to equity investor with good performances. The industry offered tax benefits under various sections of the IT Act. For e.g. dividend income is free in the hands of the investor while capital gains are taxed after providing for cost inflation indexation. Hitherto, the benefits under section 54 EA/EB were available to take benefits of the tax provisions for capital gains but have now been removed.

Like we said earlier, the appeal of mutual funds cuts across investor classes. In other developed countries, mutual funds attract much more investments as compared to the banking sector but in India the case is reverse. We lack awareness about the benefits that are offered by these schemes. It is time that investors irrespective of their risk capacities, made intelligent decisions to generate better returns and mutual funds are definitely one of the ways to go about it.

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