Mutual Funds

Merchant Banking & Financial Services

Introduction

Mutual Fund is a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document.

A mutual fund is a corporation, trust or partnership, which manages the collected money with the help of professional expertise.

The SEBI Mutual Fund Regulation, 1993 defines mutual fund as a " fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations".

In USA, the financial intermediary is known as "investment company", in the UK as "investment trusts" and in India as "mutual funds".

History and origin

The history of mutual fund can be tracked back to Europe where William I established a society in Belgium for such a purpose.

The foreign and colonial Government Trust of Lund in 1868 is considered to be the front runner of the concept of mutual Fund.

Massachusetts Investor's Trust was the first mutual fund set up in US in the year 1929.

In India, Unit Trust of India (UTI) set up the first mutual fund in 1964.

Until 1987, UTI was the sole mutual fund in the country.

Mutual Funds in India

Phase I : UTI was incorporated as a statutory corporation in 1964. The maiden scheme launched by UTI was the unit scheme of 1964 (US-64), an open-ended scheme.

Phase II: UTI's monopoly in mutual fund ended in 1987 when GOI amended the Banking Regulation Act, permitting commercial banks in public sector to set up mutual funds. The first non-UTI mutual fund was launched by SBI in November, 1987 by the name of "SBI Mutual Fund". Then, Canara Bank established its subsidiary, Canbank Mutual Fund in December, 1987. Then Indian Bank, Bank of India and Punjab National Bank during 1989-90.

The GOI then permitted insurance corporations in public sector to establish mutual funds, and LIC set up LIC mutual fund in June, 1989. Registration of mutual funds with SEBI was made mandatory and SEBI (mutual fund) Regulations 1993 came into effect on 20 January, 1993.

Phase III: SEBI accorded approval to a number of players in the private sector to launch mutual fund in October, 1993. Kothari group in collaboration with Pioneer fund, the oldest fund in US, launched Prima fund in November, 1993.

Phase IV: After 1996, the mutual fund industry witnessed a healthy growth. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI to set uniform standards for all mutual funds operating in India. The union budget in 1999 exempted all dividend income of mutual funds in the hands of the investors from income tax.

Phase V: The Unit Trust of India Act, 1963 was repealed in 2003, and UTI was bifurcated into two separate entities – US-64 scheme which assured return and certain other schemes were brought under specified undertaking of the UTI and were governed under rules framed by GOI. The second is the UTI Mutual Fund Ltd., sponsored by SBI, PNB, BOB and LIC was registered with SEBI and functions under Mutual Fund Regulations.

Mergers and acquisitions were common in mutual fund industry and many international players like Fidelity, Franklin Templeton Mutual Fund, etc. have entered India.

Structure of Mutual Fund

There are four separate entities:

Sponsor: A mutual fund is to be established by a sponsor and registered with SEBI. A sponsor can be any person acting alone or in combination with a corporate body. The requirement for sponsor are sound track record, should be carrying on business in financial services for a period of not less than five years, should have a positive net worth for the last five years, should have PAT in three years of the last five years including the fifth year, should contribute to 40% of the net worth of AMC (Asset Management Company) and should not be guilty of fraud or convicted of any offence.

Trustee: The mutual funds are established in the form of trust. The trustees should be persons of ability, integrity and standing and two-third should be independent persons. He should be appointed with prior approval of SEBI. Tre trustees are responsible for safeguarding the interest of the investors. They have the power to supervise and monitor the activities of AMC and have the power to dismiss the AMC.

Asset Management Company (AMC): A sponsor or the trustees appoint an AMC, and it should be approved by SEBI. An AMC can be terminated by majority of the trustees or 75% of the unit holders. An AMC should possess adequate professional experience in finance and financial services and should have a net worth of not less than Rs.10 crores. An AMC manages the various schemes of mutual funds with the help of professionals with adequate experience (fund managers).

Custodian: Custodians carry out the custodial services (maintenance of records) for various schemes of the fund.

Advantages of Mutual Fund:

Professional Management of funds
Diversification of Risk
Small investors can invest in securities of large companies
Different types of mutual funds for meeting different investment objectives

Operation of the mutual fund: Mutual funds offer units to the public by issuing an offer document or prospectus and collecting the funds. The money collected is invested as per the investment objective stated in the offer document/prospectus. Mutual Funds generally publish their Net Asset Value (NAV) every Friday.

Net Asset Value (NAV) of Mutual Fund

The NAV is the market value of the assets of a fund scheme for every outstanding unit as on the date of mutual fund valuation.

Net Asset Value is calculated on the basis of total asset value of a company, minus administrative expenses. It is the barometer of the performance of the scheme.

Repurchase price for units of a mutual fund is calculated after considering the net asset value. All mutual funds update their NAVs on a daily basis.

NAV= (Total assets – liabilities) / Total number of units

$$= \frac{\text{Market value of all investments + other assets – liabilities}}{\text{Total number of units}}$$

Consider mutual funds with the following investments:

X Ltd. 500 shares of Rs.10 each (current market price of Rs.40)
Y Ltd. 1000 shares of Rs.10 each (current market price of Rs.110)
Other assets Rs.10,000 Accrued expenses = Rs.15000
No. of units of the fund 10,000 units NAV = 12.5%

Types of Mutual Funds

Close-ended scheme: It has a pre-fixed maturity period. Both the corpus amount and number of units are fixed. This fund is open for subscription only for a specified period after launch of the scheme. The investor can invest in the scheme only during the subscription period. According to SEBI regulations, one or two exit routes should be provided in the form of regular repurchase or listing them in the stock exchange.

Open-ended scheme: these are available for subscription and repurchase on a continuous basis. These schemes do not have a maturity period. Investors can buy and sell units at a price fixed on the basis of NAV. Liquidity is the main advantage of this scheme.

Schemes on the basis of investment objectives

Index funds are equity funds that passively imitate a market index. The portfolio of the index fund is designed to reflect the composition of stock market index like NIFTY and SENSEX. The advantages are low costs, predictability and diversification.

Exchange Traded funds (ETFs) are passively managed funds that track a particular index and have the flexibility to trade like a common stock (combination of mutual fund and stock). It is different from index funds where units are issued in return for cash and redeemed as per the NAV in cash. However, ETF issues units in lieu of shares and vice-versa. The first ETF was S&P 500 popularly known as spiders.

Balanced funds invest both in equity and fixed income securities. They aim at regular income and capital appreciation.

Money market funds or liquid funds were initiated in 1973 in the US when interest rates on short term money market securities were high. They are also income funds and provide safety of principal and invest in money market securities.

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Gilt funds are also known as G-Sec funds. They invest only in government securities.

Growth funds are also known as equity funds and provide capital appreciation over medium to long term.

Income or debt-oriented funds provide regular and steady income to investors. The funds are invested in fixed-income securities such as bonds, corporate debantures, government securities and money market instruments. The NAV of debt funds are affected due to change in interest rates.

Sector specific funds invest in securities of those sectors or industries specified in the offer document. The return on the funds depend on the performance of these sectors.

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Tax Saving Schemes provides tax rebates to the investors under Income Tax Act, 1961. Equity Linked Saving Schemes (ELSS) and pension schemes are examples of tax saving schemes.

In Load funds, a fee is charged for entry and exit. The charge is a percentage of NAV.

No load funds do not charge a fee for entry and exit. However, they can hike the investment management fees by 1% p.a.

Systemic Investment Plan (SIP) is an investment vehicle offered by mutual funds to investors, allowing them to invest small amounts periodically instead of lump sums. The frequency of investment is usually weekly, monthly or quarterly.

Systemic Withdrawal Plan (SWP) is a facility that allows an investor to withdraw money from an existing mutual fund at predetermined intervals. The money withdrawn through a **systematic withdrawal plan** can be reinvested in another fund or retained by the investor in cash.

Portfolio Management in Mutual Fund

Active management (also called **active** investing) refers to a portfolio **management** strategy where the **manager** makes specific investments with the goal of outperforming an investment benchmark index.

Passive management is the opposite of active **management** in which a fund's **manager**(s) construct the portfolio in line with a market index. **Passive management** is also referred to as "**passive** strategy," "**passive investing**" or " index **investing**.“ An investment portfolio tracks an index and achieves low turnover, very low management fees and good diversification.