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MUTUAL FUNDS IN INDIA – ISSUES, OPPORTUNITIES AND CHALLENGES

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INTRODUCTION

Mutual Funds in India are financial instruments. A mutual fund is not an alternative investment option to stocks and bonds, rather it pools the money of several investors and invests this in stocks, bonds, money market instruments and other types of securities. The owner of a mutual fund unit gets a proportional share of the fund's gains, losses, income and expenses. Mutual Fund is vehicle for investment in stocks and bonds. Each Mutual fund has a specific stated objective. The fund's objective is laid out in the fund's prospectus, which is the legal document that contains information about the fund, its history, its officers and its performance.

Some popular objectives of a mutual fund are

Fund Objective	**What the fund will invest in**
Equity (Growth)	Only in stocks
Debt (Income)	Only in fixed-income securities
Money Market (including Gilt)	In short-term money market instruments (including government securities)
Balanced	Partly in stocks and partly in fixed-income securities, in order to maintain a 'balance' in returns and risk

The share value of the Mutual Funds in India is known as net asset value per share (NAV). The NAV is calculated on the total amount of the Mutual Funds in India, by dividing it with the number of shares issued and outstanding shares on daily basis. The company that puts together a mutual fund is called an AMC. An AMC may have several mutual fund schemes with similar or varied investment objectives. The AMC hires a professional money manager, who buys and sells securities in line with the fund's stated objective. The Securities and Exchange Board of India (SEBI) mutual fund regulations require that the fund's objectives are clearly spelt out in the prospectus. In addition, every mutual fund has a board of directors that is supposed to represent the shareholders' interests, rather than the AMC's.

GROWTH OF MUTUAL FUND INDUSTRY IN INDIA:

The Indian mutual fund industry is one of the fastest growing sectors in the Indian capital and financial markets. The mutual fund industry in India has seen dramatic improvements in quantity as well as quality of product and service offerings in recent years. The concept of mutual funds was introduced in India with the formation of Unit Trust of India in 1963. The first scheme launched by UTI was the now infamous Unit Scheme 64 in 1964. UTI continued to be the sole mutual fund until 1987, when some public sector banks and Life Insurance Corporation of India and General Insurance Corporation of India set up mutual funds. It was only in 1993 that private players were allowed to open shops in the country. Today, 32 mutual funds collectively manage Rs 6713575.19 cr under hundreds of schemes.

The industry has steadily grown over the decade. For example, before the public sector mutual funds entry, UTI was managing around Rs 6,700 crore on its own. Public sector mutual funds also helped accelerate the growth of Assets Under Management. UTI and its public sector counterparts were managing around Rs 47,000 crore when Kothari Pioneer, the first private sector mutual fund, set up shop in 1993. Before the US 64 fiasco, there were 33 mutual funds with total assets of Rs 1, 21,805 crore as on January 2003. The UTI was way ahead of other mutual funds with Rs 44,541 crore assets under management. The industry overall has performed well over the years. Of course, there were a few funds houses, which disappointed investors. However, overall performance has been good. However, lack of awareness still impedes the growth of the mutual fund industry. Unlike developed countries, most of the household savings still go to bank deposits in India. In the year 2004, the mutual fund industry in India was worth Rs 1,50,537 crores. The mutual fund industry is expected to grow at a rate of 13.4% over the next 10 years. Mutual funds assets under management grew by 96% between the end of 1997 and June 2003 and as a result it rose from 8% of GDP to 15%. The industry has grown in size and manages total assets of more than $30351 million. Of the various sectors, the private sector accounts for nearly 91% of the resources mobilized showing their overwhelming dominance in the market. Individuals constitute 98.04% of the total number of investors and contribute US $12062 million, which is 55.16% of the net assets under management.

HISTORY OF MUTUAL FUND INDUSTRY IN 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)

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 Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). 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)

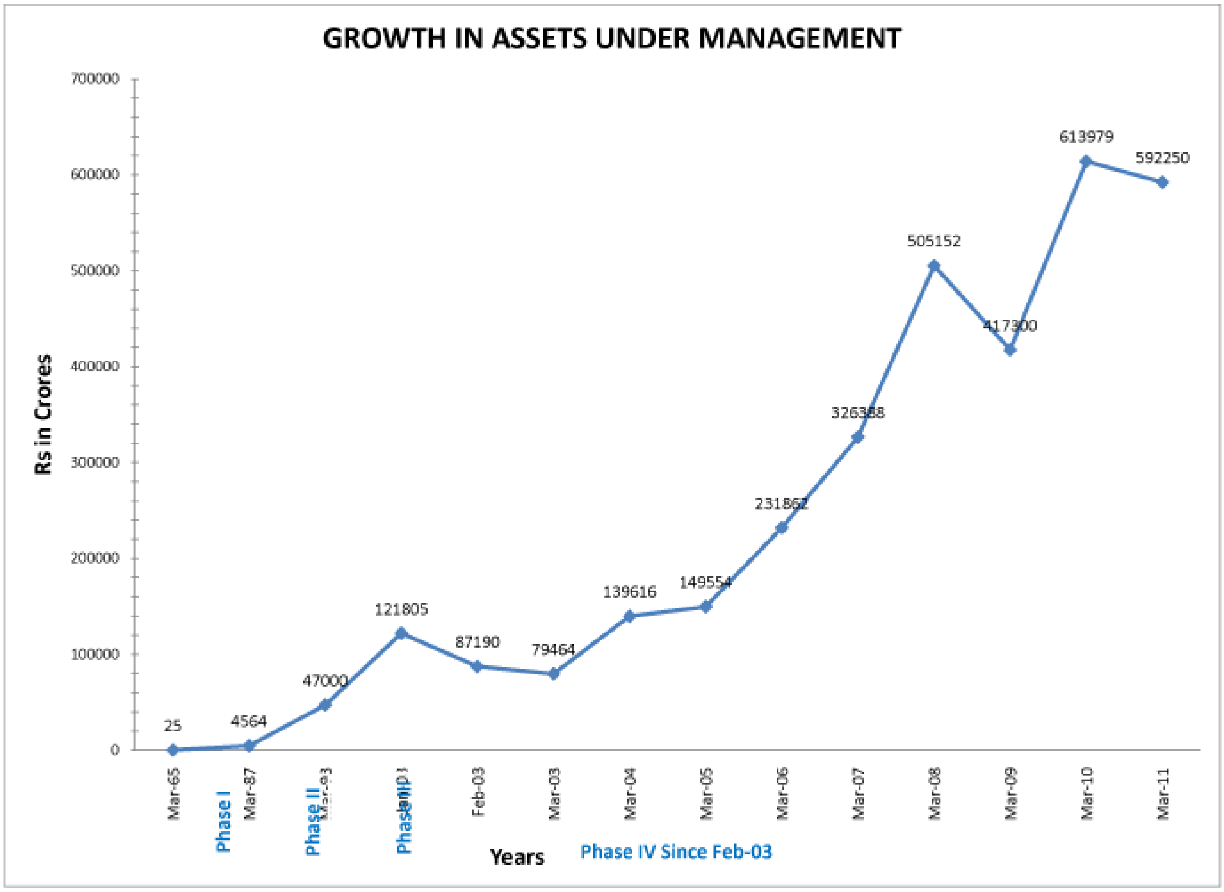
With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered 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

In 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 graph indicates the growth of assets over the years.



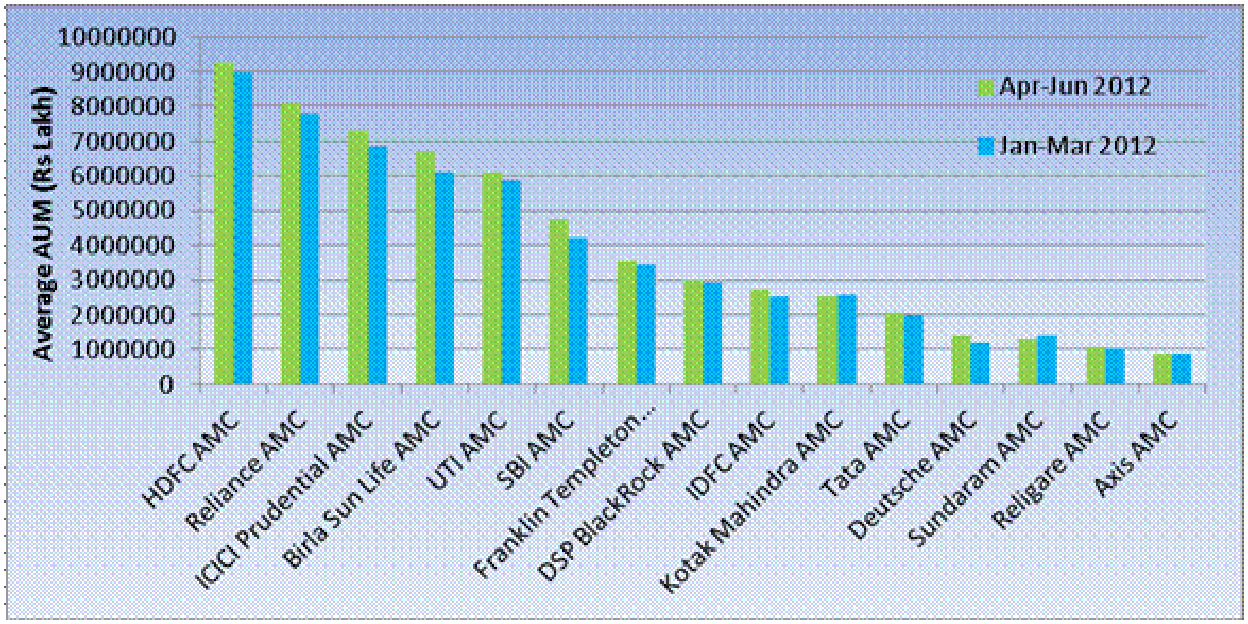
NOTE

Erstwhile UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. The Assets under management of the Specified Undertaking of the Unit Trust of India has therefore been excluded from the total assets of the industry as a whole from February 2003 onwards.

AVERAGE ASSETS UNDER MANAGEMENT AS OF JUNE 2012

The equity markets remained flat during the quarter ending 30 June 2012, with the Sensex delivering 0.14% and the Nifty losing -0.31% during the three months. The markets failed to keep up the momentum of the quarter ending 30 Match 2012 when the BSE Sensex rose 12.6%, while the Nifty advanced 14.5% during Jan-Mar 2012. In the fixed income market the yield on the 10-year benchmark GOI bond remained flat. At the same time average assets managed by the mutual fund industry increased by 4.2% during the quarter. As per the data released by the Association of Mutual Funds in India (AMFI), the combined average AUM of the 44 fund houses increased to Rs. 692,704.92 crores during Apr-Jun 2012, up from Rs 664,824.02 crores reported in Jan- March 2012.

The highlight in June 2012 was the much awaited RBI mid quarter monetary policy review, with a consensus for a minimum 25 basis point cut in key lending rates. However, in retrospect forecasters agreed that another round of rate cuts after the 50 basis point cut in April 2012 was possibly wishful thinking. Instead the RBI, in order to improve the liquidity in the system and encourage banks to increase credit flow to the export sector, raised the limit of Export Credit Refinance (ECR) from 15% of outstanding export credit of banks to 50%, which is expected to pump in additional liquidity of over Rs.300 billion.



The HDFC Mutual Fund continued its rein as the leading fund house measured by assets managed, reporting a 3.05% increase in the average assets managed by it. Amongst the largest fund houses SBI Mutual Fund gained the most in terms of Average AUM during the quarter, as it reported a 12.23% increase in assets managed. Kotak Mahindra Mutual Fund continued to report a drop in assets managed for the second consecutive quarter.

During the quarter FII activity was lackluster, as they were net sellers in equity of Rs 3245.9 crore, while they pumped in a net Rs 2741 crore in the debt market. Mutual Funds were also net sellers of equity, offloading Rs 641 crore during the quarter, while they continued to remain net buyers of fixed income securities, pooling in a net Rs 139,153 crore into the debt market.

FUTURE AND GROWTH OF MUTUAL FUNDS IN INDIA- KEY FINDINGS

According to report of Businessmaps of India, Important aspects related to the future of mutual funds in India are -

- The growth rate was 100 % in 6 previous years.
- The saving rate in India is 23 %.

- There is a huge scope in the future for the expansion of the mutual funds industry.
- A number of foreign based assets management companies are venturing into Indian markets.
- The Securities Exchange Board of India has allowed the introduction of commodity mutual funds.
- The emphasis is being given on the effective corporate governance of Mutual Funds.
- The Mutual funds in India has the scope of penetrating into the rural and semi urban areas.
- Financial planners are introduced into the market, which would provide the people with better financial planning.

According to RNCOS research report titled "Current and Future outlook of Mutual Fund Industry", key finding are –

- The Indian mutual funds retail market, growing at a Compounded Annual Growth Rate (CAGR) of about 30%, is forecasted to reach US$ 300 Billion by 2015.
- Income and growth schemes made up for majority of Assets Under Management (AUM) in the country.
- At about 84% (as on March 31, 2008), private sector Asset Management Companies account for majority of mutual fund sales in India.
- Individual investors make up for 96.86% of the total number of investor accounts and contribute 36.9% of the net assets under management.

Based on KPMG report titled "Indian Mutual Fund Industry – The Future in a Dynamic Environment Outlook for 2015" key results are-

- KPMG in India is of the view that the industry AUM is likely to continue to grow in the range of 15 to 25 percent from the period 2010 to 2015 based on the pace of economic growth. In the event of a quick economic revival and positive reinforcement of growth drivers identified, KPMG in India is of the view that the Indian mutual fund industry may grow at the rate of 22 to 25 percent in the period from 2010 to 2015, resulting in AUM of INR 16,000 to 18,000 billion in 2015. In the event of a relatively slower economic revival resulting in the identified growth drivers not reaching their full potential, KPMG in India is of the view that the Indian mutual fund industry may grow in the range of 15 to 18 percent in the period from 2010 to 2015, resulting in AUM of INR 15,000 to 17,000 billion in 2015.
- Industry profitability may reduce further as revenues shrink and operating costs escalate. Product innovation is expected to be limited. Market deepening and widening is expected

with the objective of increased retail penetration and participation in mutual funds. The regulatory and compliance framework for mutual funds is likely to get aligned with the other frameworks across the financial services sector.

OPPORTUNITIES OF MUTUAL FUND INDUSTRY

In any industry, innovation and improvements happen when the rules are changed. Large-scale environmental changes such as those that have taken place in the last three years must lead to innovation and evolution.

- Newer leaner operating structures will have to evolve which will entail the use of technology that helps an AMC (Asset Management Company) reach the retail end user with solutions that enable transactions via platforms such as mobile or online platforms. This will not only give greater direct access but will also help AMCs to better understand investor behaviour and create the appropriate environment and products to move towards long and healthy relationships with the investors.

- As the industry evolves, outsourcing an increasing number of functions to reduce the head-count and increase efficiency might be the norm. All aspects of operating costs must be examined for efficiencies.

- A rational look at schemes of an AMC by their management teams is needed to better understand the mix, the cost and the benefits – to the investors as well as to the AMCs.

- Agile product design, re-positioning of ETFs (Exchange Traded Funds) and SIPs (Systematic Investment Plans)

- Better communication of scheme returns on a relative basis to investors is required. The alpha achieved is insufficiently communicated or understood.

- The new AIF (Alternative Investment Fund) guidelines will create opportunities to broaden the revenue base without commensurate cost increases.

- The asset management industries in the US and in Japan have had their "401 k" (a type of retirement savings account in the US) moments. In the late 70s market regulators in the US permitted pension funds (later 401K) to invest a portion of their funds (at the discretion of the individual) into mutual fund schemes. This saw a huge upsurge in the AUM of the industry as a whole. Similarly the Japanese asset management industry went on a growth surge around the turn of the century when the pension and retirement funds were permitted to be invested in the asset management schemes. The EPF (Employee Pension Fund) in India is a huge pool of long-term investible funds. These are expected to yield high returns. If the right mechanism were to be created to channelise even a small proportion of the funds to be invested in the Indian mutual fund schemes (specific schemes can be selected if required), it will provide a boost to the industry, apart from maintaining the more important objective of having the funds managed by a regulated sector and by persons with a track record. Imagine the change if 20% of the 3,00,000 crore INR were permitted to be invested in the Indian capital markets via the asset management industry. It will be the industry's '401K' moment. A similar impact could be generated by introducing the concept of individual retirement accounts (IRAs). Some of the investment products available are in the nature of retirement benefit plans (EPF, PPF and now NPS (National Pension Fund) as well as certain insurance products). Avenues such as EPF are available to only a certain section of the population. To encourage people to save for the post retirement period IRAs can be offered. The investments into such schemes could be self-directed, flexible and in specific circumstances tax deductible. The fund so created could be available tax free (EEE) at the age of retirement. Such a concept exists in the mature western markets such as the US and contributes to about 20% of the assets under management!

- The recently announced Rajiv Gandhi Equity Savings Scheme is another opportunity for the mutual fund industry. We believe that given the low financial awareness of such new or first time investors in the far flung regions, it is imperative that these investors are channelised into the markets via mutual funds rather than directly investing into equities themselves!

- Advisory services to off-shore funds should be explored further as an area of revenue diversification. More could be done in this direction.

MUTUAL FUND- EMERGING CHALLENGES

GROWTH VERSUS GOVERNANCE – A RIGHT MIX

The Indian Mutual Fund industry has held its ground in the center of hard times in capital market. As number of players in the market increases, competition may force fund houses to comply not only with the laid down regulations and concentrate more on growth but efforts in creating excellence in governance as well. In this challenging environment, the debate of growth versus governance is surely set to assume greater significance.

ADMINISTRATION AND DISTRIBUTION

No discussion on mutual funds can be complete without touching upon the aspect of distribution. A lot has been spoken about the need to increase penetration of mutual funds in Tier II and Tier III cities. Rural participation in mutual funds continues to be poor. Such poor penetration has much to do with lack of investor awareness, inefficiencies in fund transfer mechanisms, presence of safer substitutes and cost of establishing presence in smaller areas. Fund houses cannot fight this battle single handedly. They need adequate support in terms of banking infra structure, distribution services and technological solutions to ensure a sustainable cost-benefit model of growth.

INVESTOR EDUCATION- A DRIVING FORCE ON FINANCIAL PLANNING

The efforts taken by the industry and AMFI towards investor education are definitely showing results. The media is also making a fair share of its contribution. Today, we have news channels, running dedicated shows for mutual funds, wherein fundamentals of investing in mutual funds are explained and queries of investors are answered by experts. However, the fact remains that in our country mutual funds are sold rather than bought and this trend has been observed uniformly across all classes of investors and for all kinds of products. This is where professional help is required. The economic boom in our country has led to the emergence of a very strong Small and Medium Enterprise (SME) sector.

THE TECHNOLOGICAL BACKBONE

Fund houses have introduced interesting technological innovations such as transacting through the internet, net asset value updates on mobile phones, unit balance alerts via SMS messages, transacting through ATM cards etc. However, these innovations currently cater to the already pampered urban class of investors. The internet revolution in our country is yet to penetrate to the grass root levels. The per capita usage of internet in our country is still very low compared not only to the developed countries but also as compared to our developing peers. Mobile telephony comparatively has grown exponentially. Herein lies another important challenge for the industry. It is very important to strike the right balance while choosing to invest in technological advancements.

DIMINISHING TALENT POOL

Print media these days has dedicated space to capture resource movements between companies, especially in the financial services sector. The acute shortage of talented resources is slowly but surely showing its impact. The pool of talented people is diminishing and staff costs are soaring. The key challenge is to find a permanent solution to tide over this acute shortage. One possible solution could be for the industry through AMFI to tie up with universities and colleges to offer programmes dedicated to the financial services industry in general and the mutual fund industry in particular, which would cover various critical aspects of the financial services industry ranging from fund management, research, analysis, treasury, operations and accounting.

WHAT WOULD THESE CHALLENGES LEAD TO…?

PRESSURES ON MARGINS

To effectively tide over the challenges, fund houses will have to expand their cost budgets which may put pressure on margins in the short run. Reduced margins may have the effect of funds houses flexing their muscles to garner a higher market share of assets under management to enjoy the benefits of economies of scale. This will surely benefit the investors in the long run as they would be able to enjoy better service standards and more product differentiation. Increasing regulations may also bring about an increase in the cost of compliance.

CONSOLIDATION IN THE INDUSTRY

Increasing challenges and growing competition may make it difficult for the smaller players to survive. With more and more new players keen on entering the market, a new wave of consolidation may spark of by way of mergers and acquisitions in the industry.

INNOVATION AND PRODUCT DIFFERENTIATION

Global fund houses are set to make their presence felt in India in a big way. Some of these fund houses are known globally for their specialization in structured products and offering an array of different choices to the investors. With competition going up in India and most fund houses offering the same bouquet of products to the investors, product differentiation could take centre stage going forward. Innovative distribution models and service standards would also be a key distinguishing factor amongst players.

INCREASING TREND ON OUTSOURCING

With the industry facing a shortage of talented resources, there is an increasing trend amongst players to outsource the non-core functions and utilize the limited available resources only for core functions to be performed in house. This is a norm in mature markets for global fund houses which may set a similar trend in our industry as well. Sensing this, more players have entered the fund accounting service provider market in the last one year.

CONCLUSION

Having crossed the Rubicon and introducing the next generation products to the investors, funds house have to now roll up their sleeves and get back to the drawing board to find effective solutions to newly emerging challenges. These are interesting times for the industry. It is rightly said that Change is the only constant. The sea of changes in the financial and economic scenario in our country has brought with it a fresh wave of opportunities. These opportunities and challenges can only lead to the betterment of the investment community at large. The message to the investors is Happy Investing!!

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