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1. Learning Outcomes

After studying this module, you shall be able to

- Learn about the history and evolution of mutual funds in India
- Derive returns from mutual funds
- Derive the skills to determine risk inherent in mutual fund and the benchmark method to measure their performance
- Understand the organization of the mutual funds and the role played by the constituting arms of the mutual fund organization

2. Introduction

Indian economy has always been very dynamic. The open mindedness of Indian government towards new schemes and formulations protects both institutional and individual investor's interest. As the financial markets have becoming more sophisticated and complex, investors need more financial intermediaries like banking institutions, insurance companies, non- banking institutions, mutual funds and housing finance companies etc. which provides the required knowledge and professional expertise on successful investing. Mutual fund represents the most appropriate indirect investment opportunity to the investors. Initially the concept of mutual fund was developed in U.S market but in Indian financial market the concept of mutual fund was entered in 1964 with the formulation of UTI. This initiative was taken by RBI and the unit trust of India.

3. History and evolution of mutual funds in India

The history of mutual fund in India started in 1964 with the establishment of Unit trust of India, as the first mutual fund in India. Before this there was no mutual fund in India. Mobilizing the savings and reinvesting these funds into different investment avenues was the basic objective behind the establishment of Unit Trust of India. A board of trustees manages the whole operations of UTI. There are four different phases into which the history and evolution of mutual fund is divided.

3.1 .Phase 1(1964-87)

In 1964, by an act of parliament the first mutual fund in India named unit Trust of India was established. During this period a complete monopoly is enjoyed by Unit trust of India, since this is the only mutual fund operating in India .Initially RBI controls the regulatory and administrative aspect of UTI but in 1978 this regulatory and administrative control was taken over by Industrial development bank of India from RBI. Till 1987 UTI was the only option for mutual fund in India.

3.2 Phase II (1987-1993)

In 1987 public sector banks got approval from the government to establish mutual funds. The first non-UTI institution that established mutual fund was the SBI mutual fund in 1987 followed by Canrabank mutual fund in December 1987, Punjab national bank mutual fund in August 1989, Indian bank mutual fund in November 1989, Bank of India mutual fund in June 1990 and Bank of Baroda mutual fund in October 1992.Till 1992 other mutual funds kept on establishing themselves. A lot of competition and improvement in terms and conditions to the investors was experienced in this period in mutual funds in India.

3.3 Phase III (1993-2003)

During this period competition in the mutual funds industry increased as the private sector mutual funds and foreign mutual funds were allowable to function in India. The first private sector mutual fund that registered in July 1993 was Kothari Pioneer, which is presently merged with Franklin Templeton. The foreign mutual funds also got the approval to operate mutual funds schemes in India in 1994. Morgan Stanley, the first foreign mutual fund in India got a huge response by the investors. The first mutual fund regulation under which all mutual funds except UTI were registered and governed came into being in 1993. In order to ensure investors protection and smooth functioning of the mutual fund industry in India, this industry was brought under the SEBI regulations in 1996.

3.4 Phase IV (1996 onwards)

The regulation that was issued in 1996 was modified during this period. For this "Mutual Fund 2000" a consultative paper was circulated and the contents of the paper were deliberated among the players of the mutual funds. As a consequence of this a new set of SEBI regulations1996 was released. The basic purpose of this SEBI regulation 1996 was to bring private sector mutual funds at par with public sector mutual funds. After 1996 a lot of foreign as well as Indian mutual funds have been established. The increase in number of mutual funds and their schemes shows that they are very popular among the retail investors and it also shows retail investors' confidence in mutual funds. At present there are more than 500 schemes of mutual funds that are operating in India.

3. Return from Mutual funds

The return performance of the mutual fund is one of the important aspects of mutual fund selection process. The potential sources of mutual fund return are the level of dividends paid by the funds, its capital gain and its growth in capital. Such return information enables the investor to judge its investment behavior and also to compare the performance of its fund in relation to other funds and investment vehicles. It depends on the type of the fund that whether the fund gives more income or more capital gain, like in case of income oriented funds we would expect much higher dividend income than the capital gain distributions.

The return on mutual fund is calculated as:

Return=Dividends+ Capital gain+ (NAV1-NAV0)/NAV0*100

NAV0=NAV in the beginning

NAV1=NAV at the end of the year

NAV1-NAV0=change over the period of time

NAV is calculated by dividing the net assets of the scheme but the number of units unsettled on the valuation date. NAV of the mutual fund indicates the value per share. NAV of the fund is estimated each day and it should be published at least in two daily newspapers at intervals of not exceeding one week.

NAV= Net assets of the scheme/ Number of units outstanding

Net assets of the scheme= Market value of the investment+ receivables+ other accrued income+ other assets- accrued expenses-other payables-other liabilities

Dividend income is derived from the dividend and interest income of the holding securities. The gross income after deducting all the operating expenses of the mutual funds is than distributed among the unit holders.

Thus the mutual fund gives returns to the shareholders in three ways; first they pass the income from dividends or coupon payment of securities in the form of dividend payments to the shareholders. Secondly the capital gain from sale of securities is distributed to shareholders within the fund. Third form of return distribution is the mutual fund share price appreciation. In this as market value of the fund's security increases, the NAV of the fund increases and ultimately the shareholder benefit when they sell their mutual fund shares.

5. Method to determine risk that is inherent in mutual fund and the benchmark method to measure their performance

Risk is inherent in every investment decision. Since mutual funds invest in various securities their investors are exposed to the business and financial risks that are normally present in individual securities. In mutual funds the investment in securities are well diversified but still most of the funds is exposed to a considerable amount of market risk. In fact most of the mutual fund portfolio tends to perform much like the market that is being targeted by the fund, although a few of the funds are defensive in nature. Therefore in large number of portfolios market risk is an important behavioural ingredient.

Management practice of the fund is another important aspect of the mutual fund risk. The risk of the loss in capital is likely to be much less when the portfolio is managed conservatively as compared if the fund is managed aggressively. Obviously if the management practice is very speculative there will be higher risk of instability in the net asset value. However it is not necessary that a conservatively managed fund eliminates all the price volatility. Inflation, interest rate and general market risks always lies with the securities in the portfolio. Generally these risks are reduced or minimized as the investment objectives and portfolio management practice of the funds become more conservative.

Thus we can say that as the mutual fund has diversification feature it reduces the risk but does not completely eliminates it. If anyone decides to participate in equity market or in debt market through mutual funds, the risk associated with those markets still remains with the mutual fund. It can be possible that the impact of investing through mutual fund is less as compared to investing directly. There are various methods with the help of which we can quantity the risk associated with the mutual fund these are:

1) Alpha

Given the beta of the portfolio alpha is the alteration among the returns an investor expects from a fund and the return in fact receives. A positive alpha means that the fund has achieved better than its benchmark index on the other hand a negative alpha indicates underperformance of the fund. The more positive the alpha, better is the investor.

2) Beta

It is measure of volatility in the returns of the fund. It measures to what extent the fund's return is impacted by the market factors. Beta of 1 specifies that the fund will move in the same direction as the benchmark index. A beta of less than 1 specifies that the fund is less volatile than the benchmark index and a beta of more than 1 specifies that the fund is more volatile than the market index. Generally conservative investors' focuses on mutual fund schemes with low beta and aggressive investors opt to invest in schemes that are having high beta.

3) Standard deviation

Standard deviation procedures the total risk of the fund. It conveys how much the return of the fund is deviating from the estimated returns which is based on its historical performance i.e. it estimates the volatility of the fund. A higher standard deviation specifies that the NAV of the mutual fund is more volatile and riskier than that of the fund with lower standard deviation.

In order to define the performance of the mutual fund both risk and return aspects are considered. The management's performance is measured by comparing the yield of the managed portfolio with the market index. For this purpose three popular measure of performance is employed. These are

1) Treynor measure

According to Jack Treynor the appropriate measure of risk is the systematic risk or beta. This measure relates the excess return on a portfolio to the portfolio beta.

Treynor's measure= Excess return on a portfolio/ Beta of the portfolio

The excess return of the portfolio is the excess of return earned by the portfolio in comparison to the rate of return on the risk free investment. The Beta of the portfolio measures the systematic risk of the portfolio. Since Trenor use beta to measure performance , this measure implicitly assumes that the portfolio is well diversified.

2) Sharpe measure

This extent employs standard deviation to measure the risk. Thus this method is quite similar to the Trenor method except that Trenor use the beta while Sharpe uses the standard deviation to measure the risk of the fund.

Sharpe measure = Excess return on a portfolio/ Standard deviation of the return of portfolio

Standard deviation measures the total risk of the portfolio. Hence Sharpe measure shows the excess return earned on a portfolio per unit of its total risk. The larger the Sharpe index the better is the performance of the portfolio or fund.

3) Jensen measure

This measure is built on the capital asset pricing model. This quantity, given the beta of the portfolio reflects the modification among the return actually earned on a portfolio and the return that the portfolio was supposed to earn.

Jensen measure= Average return on portfolio-(Risk free return+ Portfolio beta(Average return on market portfolio-Risk free return))

Most of the fund evaluation services rely on Jensen measure as it is a risk adjusted measure. If the value of Jensen measure is positive then the fund is considered to be of good quality on the other hand if we have negative Jensen measure it is considered to be bad. The neutral value specifies that the fund is performing in the same manner as the market portfolio.

In April 2002, SEBI made benchmarking compulsory for the mutual funds. In every half yearly result, the presentation of mutual fund schemes has to be disclosed along with the presentation of benchmark index.

6. Organization of mutual fund and the role played by constituting arms of mutual fund

A mutual fund is a fund that is recognized in the form of a trust. They raise the money under different schemes for the purpose of investing in various securities. A mutual fund is constituted under the Indian Trust act 1882. The various constituents of a mutual fund structure are sponsor, Board of trustees, Assets Management companies, mutual fund, custodian, bankers, agents and distributors etc which are described as under:

5.1 Sponsor

A person who creates a mutual fund either alone or in combination with another body corporate is a sponsor of mutual fund. A sponsor acts same as that of promoter of a company. As per SEBI regulations a sponsor is responsible to form a trust and to appoint the board of trustees. Sponsor generally appoints the assets management company as fund manager and also a custodian to hold the fund assets. A sponsor must retain a sound financial track record previous to registration and must give at least 40% of the net worth of the AMC.

5.2 Trustees

A mutual fund able to by the board of trustees or by the trust company. Board of trustees is a body of individuals and the trust company is a corporate body. In India most of the funds are managed by the board of trustees. The property of the mutual fund is hold by the board of trustees in trust for the advantage of the unit holders. It is the responsibility of the board to ensure that the mutual fund is managed by following all the statutory provisions and the guidelines related to it. However the board of trustees does not directly manage the portfolio of securities. The board of trustees is the primary guardian of the unit holders units and assets.

5. 3 Asset management company

The asset management company acts like the investment manager of the trust. It is selected by the promoter or the trustees and is permitted by the SEBI. The AMC makes investment in various types of securities and manages the funds of the mutual fund schemes. The AMC works beneath the supervision of its own board of directors and also keep an eye on the directions of the trustees and SEBI. As per SEBI regulations 50% of the directors of AMC must be self-determining.

5.4 Mutual fund

In India mutual fund is constituted in the form of a trust under the Indian Trust act 1882. The fund pools the saving of large number of investors through the sale of shares and invests them in various securities. The assets of the trust are held by the trustees for the benefit of the unit holder. Under the Indian trust act the legal capacity of the trust lies with the trustees and the fund do not have any independent legal capacity.

Apart from these custodians, depositories, banks, transmission agents and distributors are some other voters of a mutual fund. They are appointed by the board of trustees and provide various types of financial services to the mutual fund. For the purpose of safe keeping of securities and participating in the clearing system the custodian is appointed through approved depository. The financial dealings of the fund are handled by the bankers. For issuing and redemption of units of mutual fund the transfer agents are responsible. The distributors or brokers sells the units on behalf of the fund and also serves as the investment advisor.

7. Summary

- In India investors need more financial intermediaries that provides them the required knowledge and professional expertise on successful investing.
- Mutual fund represents the most appropriate indirect investment opportunity to the investors.
- In India the history of mutual fund started in 1964 with the establishment of unit trust of India.
- In 1987 public sector banks got approval from the government to establish mutual funds.
- In 1993, the competition in the mutual fund industry increased as the private sector mutual funds were allowed to operate in India.
- Kothari pioneer was the first private sector mutual fund in India.
- In 1994, Morgan Stanley was the first foreign mutual fund in India.
- In 1996 the mutual fund industry was brought under the SEBI regulations in order to protect the investors.
- At present there are more than 500 schemes of mutual fund that are operating in India.
- Mutual fund return is one of the most important aspects of mutual fund selection process.
- The sources of mutual fund returns are the level of dividend paid, its capital gain, and its growth in capital.
- Mutual fund return enables the investors to compare performance of its fund with that of some other fund.
- The diversification feature of mutual fund helps to reduce the risk but it does not completely eliminate the risk.
- Mutual fund investors are exposed to business and financial risk that are normally present in individual securities.