CHALLENGES IN MANAGEMENT OF MUTUAL FUNDS IN INDIA

GURDEEP SINGH BATRA and B.S. BHATIA

Mutual funds are essentially portfolios, which co-mingle the savings of a large number of individuals in a large diversified investment portfolio. Mutual funds claim to offer professional management of funds to diversify and thus to reduce the unsystematic risk, while offering good returns. Mutual funds have long been popular in the developed economies. In India the first mutual fund to be established was the Unit Trust of India. State Bank of India established a mutual fund in 1987, and since then a number of public sector banks and other public sector corporations have established mutual funds. The regulatory framework in India does not permit establishment of mutual funds in joint/private sector till date. However, private companies offer portfolio management services outside the ambit of mutual funds. A few foreign and Indian banks have established funds which are based abroad for non-resident Indians and for investment in Indian stock markets. The rapid growth that mutual funds have witnessed point to increasingly important role that mutual funds are slated to play in future.

A mutual fund combines the capital of many investors with employment of an experienced agent in purchasing securities of various companies, thereby providing diversification and supervision which the investors may not be in a position to afford individually. Mutual fund also combines in one stock certificate the convenience and satisfaction of owning share in many industries.

Mutual funds constitute the fourth largest financial force in the US after banks, insurance companies and pension funds commanding aggregate assets of over $300 billion (Rs. 360,000 crores). There was a boom period for mutual funds in 50s and 60s but 70s suffered a big setback. Only in early 80s things again started looking up. In 1984, $300 billion were invested by mutual funds in corporate securities. Over one thousand mutual funds were active, managing the investment in over 21 million shareholder accounts.

Mutual funds have taken many turns and now the profile of this financial

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Dr. Gurdeep Singh Batra is Faculty Member, Deptt. of Business Management, Punjabi University, Patiala.

Dr. B.S. Bhatia is Professor, Deptt. of Business Management, Punjabi University, Patiala.

institution is assuming a new shape. With the renaissance of mutual funds a change is taking place in the composition of investors. The traditional investors who used to invest in mutual funds, keeping in view the college education for children and retirement age, are giving way to youngest generation with shorter time horizon and greater expectations. There is a growth in the number of young people with growing expectations which has started causing strains in mutual fund structure. While expectations are increasing, the industry is working with old software. The six mutual funds of the U.S.A. which recorded high growth rates in 1983 provide some glimpse into the working of successful mutual funds. These mutual funds are being managed by professionals graduating from the colleges of management. Their approach to investment is more in terms of looking for companies with strong management, promising products, sound financial and marketing strategies. Few of them rely on market tips or mere hunches. Most of these managers are very young and almost all of them are achievement-oriented. The striking feature is the domination of youth in the industry. While the managers are young, ambitious and dynamic, the investor's profile is becoming more and more young and sophisticated. Thus industry is getting dominated by the youth.

The realisation that no single investment product could meet all the financial needs of investors has led the mutual funds to develop a wide variety of products. There is mutual fund for every investor need. In seventies, almost 94 percent of all mutual fund assets were associated with equity mutual funds but in early eighties they accounted for only 17 percent. During this period the mutual funds business experienced a big change. Investors' emphasis on yield and relative safety moved mutual funds in the direction of income oriented portfolio as against growth oriented investment. The industry introduced money market funds, municipal bond funds and bond funds.

Objective of Mutual Funds

In the United States, the open-end investment companies are required to publish and adhere to the fund's investment objective. The investment objective of mutual funds helps the prospective investors in selecting the best suited mutual funds. The prospective investors may select the mutual fund whose investment objective is similar to their own objective. These investment objectives may be classified as follows:

Growth Funds

Such types of funds invest in only common stock and plan to assume some risk in order to earn higher returns.

Income Funds

Income funds have the objective to invest in those stocks and bonds that pay high cash dividends and coupon interest. Blue-chip stocks are preferred to in-

vestment in risky stocks offering higher potential capital gains.

Balanced Funds

These funds divide their investments in fixed income securities and low risk common stocks in order to avoid the risk of loss.

Liquid Asset Funds

Such type of mutual funds are also called money market funds because they invest in money market instruments such as Treasury Bills.

Municipal Bond Funds

Municipal Bond funds invest only in municipal bonds to obtain their tax exempted income. Usually, the shares of these funds are purchased by only substantial individuals who are in high income tax brackets.

Corporate Bond Funds

In order to earn interest rates that are higher than the Treasury Bond, these mutual funds invest in the bonds of business corporations but at the same time without taking as much bankruptcy risk as taken by the common stock investors.

Earlier Studies

In India, till recently, no study subjecting the mutuals to rigorous scientific analysis had been conducted, primarily due to comparatively short period of existence of Mutual Funds. However, mufuals in the U.S.A. have been subjected to rigorous analysis.

Smith and Tito [1](1969) conducted a study on 38 funds for 1958-67 period and obtained similar results. Treynor [2](1965) advocated the use of Beta coefficient instead of the total risk. He argues that using only naive diversification, the unsystematic variability of returns of the individual assets in a portfolio typically averages out to zero. So, he considers measuring a portfolio's return relative to its systematic risk more appropriate. However, McDonald [3](1974) examined 123 mutual funds for 1960-69 period using both Sharpe and Treynor measures and found both measures to be closely correlated. More importantly, he found that on an average, mutuals perform about as well as a naive 'Buy and Hold' strategy. Jensen [4](1968) measured the performance as the return in excess of the equilibrium return mandated by Capital Asset Pricing Model. Fame (1972) had broken down the observed return into four components:

(a) the risk free rate of return;

(b) the impact of systematic risk;
(c) the impact of imperfect diversification; and
(d) returns due to selectivity.

If mutuals perform about as well as a naive "Buy and Hold" strategy in a developed market, can we expect the relatively inexperienced fund managers in India to out-perform the market? Some studies have been carried out in this direction and have evaluated the performance of mutual funds in India. However, these studies have been few primarily due to short life of funds,their (funds') hesitation to open themselves to public scrutiny and due to only few funds being listed in the stock exchanges. However, such studies have been severely limited in scope and have not used the tools described earlier, with the notable exception of Barua and Verma[5] (1991).

Barua and Verma (1991) have evaluated Mastershare. They have analyzed Mastershare for the period July 1987 to Sept. 90. The annualized return on Mastershare for this period is 70.60% against 41.40% for the market. The annualized standard deviation of Mastershare is 41.31% as compared to 19.44% for the market. Assuming 12% to be the risk free rate of return, risk premium of the market and Mastershare is 29.4% and 58.6%. This implies 1.512% and 1.418% reward per unit of volatility for the market and the Matershare. The return of 70.6% as compared to market (4.14%) is prima facie high but when risk assumed is taken into account the compensation for risk assumed (1.418%) is poorer than that provided by the market (1.512%). The beta coefficient of undiversifiable risk for Mastershare is 1.121. The reward per unit of beta offered by the market is 29.4% and 52.3% for Mastershare. This is a performance far superior to the market.

Mutual Funds in India

The past decade has witnessed a phenomenal growth of the capital market in India. The change made in FERA i.e. dilution of equity holdings by a number of foreign companies in the late 70s and important policy initiatives like 'Industrial Policy' statement in 1980, technical policy statement in 1983, portfolio investment policy for NRIs in 1983, broad banding of industry in 1984, delicensing of industries, increasing the assets threshold limit of MRTP companies, exempting export earnings from tax, raising the limit to Rs. one crore in capital exemption order, setting up of a Securities Exchange Board of India (SEBI) etc., provided a boost to the primary and secondary markets. The number of individual share holders is increasing at a very fast rate. No doubt the primary and secondary markets made good progress after 1980 in terms of capital raised, number of listed companies, amount of capital of listed companies, underwriting, and turnover in various stock exchanges. Still there is an urgent need to activate the capital market as the general public is still hesitant to invest in industrial securities because of uncertainties, pitfalls, price manipulation in the stock market by the interested parties, insider trading, kerb trading, option dealing etc. The introduction of mutual funds, a new

financial instrument, can help in solving this problem as mutual funds are managed by full time professional money-managers who make all the investment decisions on behalf of investors.

The public sector mutual funds (promoted by banks, LIC and GIC) other than those of UTI have achieved phenomenal growth in the preceding four and a half years. The UTI has largely been there since 1964 and has been playing a crucial role in the Indian capital market. These newly created funds have been collectively able to mobilise savings of the magnitude of more than Rs. 10,000 crores. According to Dr. S.A. Dave, the number of mutual funds, which is now about eight, would rise to anything between 20 and 25 in the next two to three years. At this rate of growth, these funds are most likely poised to out-perform the UTI as far as the availability of total investible funds with these institutions is concerned. Further, according to the RBI Governor, the scope for various mutual funds to mobilise household savings is not going to be exhausted as currently these funds are on the average, just garnering Rs. 5000 crores per annum as against the total availability of Rs. 20,000 crores per annum from the savings of the household sector.

In addition to meet the various investment objectives of various classes of small and medium investors the mutual funds are presumed to provide better returns, liquidity, safety, stability hedging against inflation through professional expertise and sound portfolio management of these funds. Further, these funds are being launched for mobilisation of additional household savings from rural and semi-urban areas. The record collection of funds under different schemes from individuals as well as from corporate sector shows the strength and popularity of mutual funds. It may be noted that the contribution of the corporate sector has been to the extent of around 30 per cent of the total mobilised funds.

Performance of Mutual Funds

These new instruments are expected to infuse greater competitiveness, flexibility and efficiency into the capital market. Though they have been the most popular form of investment in USA and other developed countries for the last two decades, the Indian investor was first exposed to them in a big way only in 1986. At present there are four Indian based mutual funds operated by UTI, SBI, Canara Bank and LIC. Besides these operational mutual funds other financial institutions like PNB, Indian Bank, Canara Bank, ICICI, etc., are on their own jointly entering into mutual fund business soon.

Mutual fund is a new concept in India, though its close associate Unit Trust came into existence in 1964. The performance of UTI was not very impressive in its initial years but has improved steadily and substantially in the recent past. UTI is in public sector, and in the private sector only a few investment trusts are in operation. During 1983 and 1984, however, there has been a new surge of enthusiasm about mutual funds. It has come in the wake of a leasing boom and has caused a few ripples but still no big waves. In other words, it is still in infancy stage, but promises to grow at a fast rate. A few

companies that have entered in the field are Nagarjuna Investment Trust (NIT), Hyderabad; HIFCO Growth Fund, Hyderabad; the First Growth Fund of India, Bangalore; the Pioneer Growth Fund of India, Bombay etc. NIT has offered for public subscription shares worth Rs. 2.4. crores apart from shares of Rs. 1.6 crores reserved for allotment to the promoters, directors, relatives, friends, and business associates. It wants to mobilise small personal savings and collectively invest them in equity shares, convertible debentures, secured debentures and other corporate securities by maintaining a balanced portfolio. It proposes to undertake a wide range of activities, while the major thrust would be in portfolio investment. It is planning to set up service in the nature of merchant banking and loan syndicate. HIFCO claims that it has pioneered the concept of mutual fund in India in 1982 by organizing a pilot project to collect small amounts from the subscribers of HIFCO publications. The First Growth Fund of India, Bangalore, is a closed-end fund; its objectives include providing current income as well as long-term capital appreciation. It wants to undertake a wide range of activities in the area of finance and investment management. Pioneer Growth Fund is proposing to invest in growth-oriented shares by identifying growth companies.

One of the important features of these funds (actually investment companies) is that most of them are already in leasing and/or hire purchase business. Since these funds do not get the tax benefits as enjoyed by the UTI, they have planned compensation for it by using leasing as the tax shield. These companies have got plans to organize research cells to take investment on a scientific basis. Most of these companies want to manage growth funds and not balanced funds. They want to deal in the equities of fast growing companies. This ambition for growth may prove troublesome. These companies have tried to get the services of experts from banking, finance and academic fields with a view to introducing professionalism.

Another interesting development in this area is the organisation of mutual funds by the reputed industrial houses such as Birlas and Tatas. Birlas are engaged in collaboration with foreign banks to tap non-resident investment. They propose to launch mutual funds in collaboration with Warburgs, a leading merchant bank of London. This is aimed at establishing an open-end mutual fund in Channel Islands, a tax haven. The off-shore fund that would be raised by overseas Indians would be utilised for investment in shares of Indian companies and eventually in ventures for setting new projects particularly those involving high technology.

The performance of various mutual funds (both off-shore as well as on-shore) in terms of returns to investors (dividends, bonus and rights issues, and income distribution) and mobilisation of funds from the capital market has been highly commendable. The UTI, the LIC's MF and the SBI's MF have been in the capital market for many years. Their dividends have been ranging between 11% and 16% p.a. Some of the other MFs (e.g. Can Bank MF) have delivered rather unreliable high returns. A detailed view of the performance of Can-bank MF, Indian Bank MF and PNB MF can be seen to be very good when compared to the other MFs. Thus, as compared to other MFs these

MFs have been quite conservative so far as the returns to investors are concerned.

One of the objectives of launching MFs has been to garner additional household savings. There have been reports that bank deposits in the preceding two years have shown a decline. Further, there have been reports that even the UTI sales are showing a decline (e.g. the corporate sales of units during the month of July, 1991 might not have exceeded Rs. 10 crores). This implies a fall of more than Rs. 325 crores in corporate sales when compared with the corresponding figure of Rs. 327 crores last year. Further, it has been reported in the Press that there is every likelihood of a decline of UTI sales to individuals which is estimated at Rs. 200 crores as against of Rs. 250 crores in July 1990. Thus units seem to have lost their attractiveness as money market instruments for corporate sector to deploy their short term surpluses. It seems that because of the availability of a number of money market instruments and the popularity of the mutual funds in the corporate sector, the era of units (those of the UTI) as the principal money market instrument during the eighties seems to have come to an end. There are reports that even the UTI fears being dumped and accordingly it has started paying better returns as against the fact that it has been very conservative as a paymaster (just as the LIC is) in the past. All this has an implication: whether it is a mere transfer of funds from banks and UTI to MFs? From the record of returns delivered to investors it is clear that in general most of MFs promoted by banks have so far paid higher returns to investors. However, the fall of funds with banks, UTI, LIC, and CIC would certainly result in restricting their earlier roles as laid down by the Government policies.

The UTI, the LIC MF, the GIC MF and the MFs promoted by various banks have enormous funds at their disposal for investment in the equity market. Enough evidence is available that in the past too, investment and disinvestment decisions by these FIs and MFs have fueled speculative activity in the capital market. Last year there was a lot of hue and cry by the stock market authorities about the fact of persistent fall in share prices and they have been demanding that MFs should come to their rescue. Even in September this year (1991) there have been reports of speculative activity by these funds. According to a press report the rise in stock prices even after the fact that the RBI has forecast a slowdown in growth, gives credence to the fact that "We should discard the theory that stock markets are barometers of the Indian economy".

In the past one of the roles played by the UTI and the LIC MF was to provide stability to stock market. However, the Govt. has not laid any such strict guideline for these bank-promoted MFs. The activities of these funds are mostly restricted to some high priced selected scrips in specified list. Also these funds generally trade in secondary market. In general the 'floating' stock remaining the same, the share prices behave according to the behaviour of these MFs. The funds are not allowed any preferential allotment in promoter's quota. All these funds have different managements and yet operate more or less under the Govt. Thus, there is as yet lack of competitive-

ness in true sense.

Emerging Dimensions

There are different types of mutual funds. They can be classified on the basis of capital structure and financial objectives.

(A) Capital Structure
  (i) Open ended
  (ii) Closed ended
(B) Financial objectives
  (i) Growth funds
  (ii) Income funds
  (iii) Saving funds

In open ended mutual fund, the number of shares is not fixed; it varies from day-to-day as investors enter or leave the fund. One can enter the fund at any time by buying the shares of ,mutual fund company at the announced purchase price and leave the fund by selling the shares of the issuing company at repurchase price. In closed ended mutual funds, the number of shares is fixed unless subsequently increased through rights or bonus issues. These are openly traded on the stock market after their initial public issue is listed. UTI's mastershares and Can shares are closed ended mutual funds whereas units of UTI are an open ended mutual fund.

The various income funds are units of Unit Trust of India, Magnum Regular Income Scheme 1987 (MRIS, 87), Magnum Regular Income Scheme 1989 (MRIS, 89), and Magnum Monthly Income Scheme 1989 (MMIS, 89). Can 80 cc and Magnum Tax Saving Scheme (MTSS) are tax saving schemes while Can growth and UTI's mastershares are growth oriented schemes.

The UTI also raised the funds through mutual funds in the international market. In 1986, UTI introduced the Indian Fund which was quoted in the London Stock Exchange. In 1988 they introduced the Indian Growth Fund quoted on the New York Stock Exchange. The SBI Capital Market introduced the Indian Magnum Fund N.V. UTI also announced two more schemes for Indian investors i.e. Equity Linked Saving Scheme (ELSS) and Land Mark Unit for housing and construction.

Mutual Funds help in mobilising the savings of the people and invest them in corporate and government securities. The mutual fund companies earn income through dividend, interest and capital gains which is passed to the mutual fund holders.

Each mutual fund has a well diversified securities e.g. the fund raised through UTI's Mastershares is invested in 136 companies belonging to 17 different industries. This is not possible in the case of individual investors having small sums of money. In the case of investors having large sums of money, the shares of good companies are not easily available and it may take a very long time period to build a well diversified investment portfolio.

Thus the interest of the mutual fund investor is protected in a better way and it also builds confidence in the investors as their interest is watched by the professionals/specialists who have up-to-date knowledge and easy access to the capital market.

UTI's mastershares is the biggest and most important mutual fund currently operating in India. It began with a fund of Rs. 150/- crores comprising 15 crores shares of Rs. 10 each, the trading lot being one hundred shares. Thereafter it raised another Rs. 90 crores in 1989 through a rights issue of one for two at a premium of Rs. 2 per share. In three years period, 1986-89, the size of the fund expanded to around Rs. 500 crores. The net asset value (NAV) was in the range of Rs. 21-22 in May 1989. It has registered a capital appreciation of 120 per cent over a period of three years and declared a dividend of 8 per cent in 1987, 13 per cent in 1988 and 18 per cent in 1989. On an average the compound rate of return (dividend and capital appreciation) is around 40 per cent per annum. There are roughly 5 lakh shareholders.

Can share like Mastershares is a close ended mutual fund, issued by Canara Bank. Its facevalue is Rs. 100 and is quoted on all major stock exchanges in India. The rate of return from these is around 20 per cent. Canstock is a growth cum income scheme.

The mutual funds issued by State Bank of India are called Magnums. MRIS gave a rate of return of 23 per cent out of which it distributed a dividend of 13.5 per cent; and 14 per cent Magnum Tax Savings Scheme is similar to Can 80 cc Scheme.

No doubt the performance of mutual funds schemes is equally good in comparison with industrial securities. The public response is also encouraging. It appears that in future the mutual funds will be a very important source of industrial finance.

The mutual funds schemes operating in India need certain modifications relating to multiple laws governing mutual funds, disclosure of information, limit of investment of mutual funds in a single company, listing of mutual funds in stock exchange, removing urban bias etc.

Future Prospects

The success of mutual fund depends essentially on the buoyancy of capital market in the country. The number of investors in corporate securities has increased to more than seven million as against two million in the recent past and now constitutes one per cent of the population as against 30 per cent of population in the US taking interest in corporate securities. The dilution of equity ownership by FERA companies has generated a keen public interest in corporate securities. The suspicion, misgivings and apprehensions associated with the shares and other securities seem to be gradually declining. This is supported by the over-subscription of a number of issues and also by an active response to debentures and deposits.

There has been a significant increase in the number of listed companies, shareholders and stock exchanges in the last few years. The rapid in-

dustrialisation of the country as envisaged under the Five Year Plans would further create the demand for additional funds. The management in the corporate sector is inclined more to raise funds from the individual investors as against financial institutions and institutional investors after seeing the episode of Escorts and LIC. The saving rate in India of 23% of G.D.P. provides an excellent opportunity of tapping the savings for investment in the organized corporate sector.

UTI can hardly meet the increasing requirements of funds of our corporate sector. There is need for the systematic growth of mutual funds in the private sector by providing the necessary fiscal incentives and facilities. There is need for organizing publicity to create interest of the investors in corporate securities not only in urban but also in rural areas.

Suggestions to Make Mutual Funds Effective

(1) The management of mutual funds should be highly professional and free from the clutches of transferable bureaucrats. The managements of these funds should be legally accountable to investors for violating the 'general objectives' of the fund. Apart from the other objectives, the interest of small investors pertaining to profitability should be duly taken care of.

(2) The Govt. should, at the earliest, enact necessary legislation for the effective operations of the SEBI in respect of mutual funds.

(3) In USA, the evidence on operational efficiency has been negative. Mutual funds have not succeeded in bringing economies of scale. Indeed, the larger funds have had higher management and trading expenses. The Govt. should impart due consideration to this aspect as the returns to investors are certainly affected.

(4) The Govt. has already agreed in principle to permit mutual funds in the private sector. Therefore, after proper consideration of all aspects, the scope for greater competitiveness must be enhanced in the interest of efficient allocation and utilisation of these productive resources.

(5) There is every likelihood that the investible funds at the disposal of UTI, LIC and banks would decline with the growth of mutual funds. Therefore, the Govt. should pay necessary consideration to the provision of adequate funds to priority and other socially desired sectors.

(6) Some independent institutions should be created to provide information about risk-return and overall ratings of the different mutual funds on the lines of Morningstar Inc., the mutual fund rating service based in Chicago (USA).

(7) The desirability of controlling and regulating all mutual funds within a uniform pattern should be thoroughly pondered over.

(8) The fears of the promoters of enterprise in the private sector regarding the erosion of control and ownership 'in company management must be given due consideration and appropriate steps should be taken by the Govt.in the 'regulatory framework' itself.

(9) The small investors should be made more and more aware of the implications of various mutual fund schemes. Further, these investors should be made aware of the agencies through which their grievances can be redressed.

(10) The Govt. has already declared to liquidate twenty per cent equity of some profit making public sector enterprises. Existing and newly created mutual funds may be involved in this task.

Conclusion

The encouraging public response to the mutual funds reveals the potential of mobilising the savings of the masses for industrial finance. Effective exploitation of this potential in a manner fair to all concerned – the investor, the fund and the economy – calls for uniform rules regarding disclosure of information, listing of mutual funds in stock exchanges, entry to mutual fund business, removal of urban bias and limit of investment of a mutual fund in individual companies or ventures.

The managers of the mutual funds have to accept the challenge to analyse the needs and investment preferences of the investors and devise schemes to suit their needs. If mutual funds want to remain a sustained force and not a flash in the pan, they have to realise the socio-economic realities of the nation and develop funds which are indigenously suited as also gain from the experience of other countries.

The Government must also be cautious against the mushroom growth of mutual funds. It should not allow the unregulated growth like that of the leasing companies. The Government has already taken certain measures in this regard. The listing norms of investment companies have been tightened. Now, the Government of India has made amendment through Securities Contract (Regulation) Rules 1984 under which a company can become a member of the exchange. If the mutual fund companies are also allowed to become the members like CANFINA, SBI Capital Market, PUNCAP, etc. they can help a lot in building confidence in the investors and motivating the masses for investment in industrial securities through mutual funds.

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