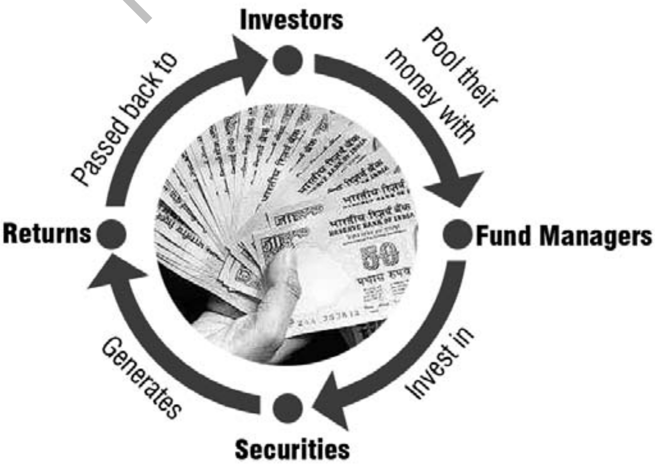
CHAPTER 1

MUTUAL FUND **EVOLUTION**

1. WHAT IS A MUTUAL FUND?

- A Mutual fund is in the nature of a "Collective Investment Vehicle".
- This means that it pools the resources of like minded investors for investment in a diversified portfolio.
- Its investment strategy is based on the objectives laid down in the Offer Document.
- Each investor is a co-owner, though at different percentages. Hence ownership of the fund is joint or "Mutual".

> Investors pool their money with a fund manager who invests it in securities that generates returns which is then passed back to the Investor.



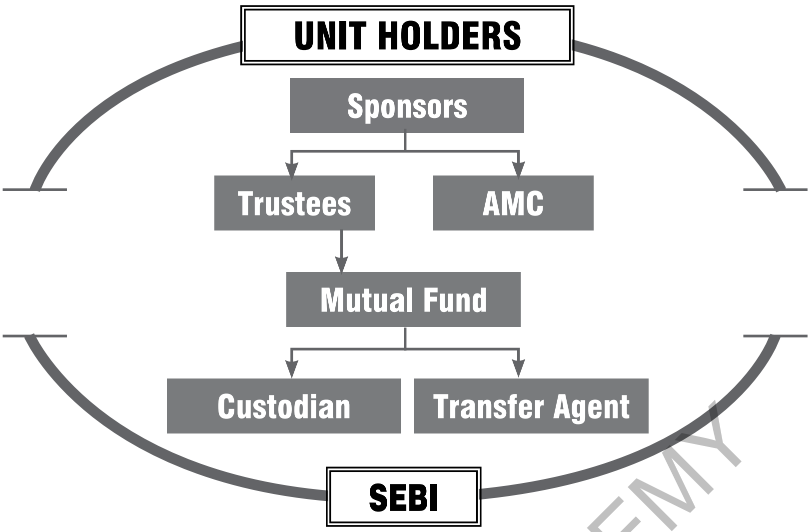
2. What is the organizational structure of Indian mutual funds?

- A Mutual fund is constituted as a **Trust** under the Indian Trust Act, 1882.
- The Fund **Sponsor** acts as the settlor of the Trust and contributes the initial capital of the mutual fund. In that sense the sponsor is an investor.
- The Sponsor appoints **Trustees** to hold the assets of the fund in a fiduciary capacity on behalf of the unit holders (Investors).
- The Fund invites **Investors** to contribute their money to the common pool. This is done by subscribing to the units issued under various schemes established by the Trust. Each fund scheme is a separate portfolio and is handled normally by separate fund managers.
- The Sponsors incorporate a company under the Companies Act, 1956 to act as **Asset Management Company (AMC)**. The AMC is required to be approved by the Securities and Exchange Board of India (SEBI) and manages the funds by making investments.

3. Who are the participants in a mutual fund?

The following is a partial list of people who are associated with a mutual fund in different capacities

- Sponsor
- Board of Trustees
- Asset Management Company
- Custodian
- Registrar and Transfer Agents
- Regulator – SEBI and Association of Mutual Funds in India (AMFI)
- Investors.



4. Who is a fund sponsor?

- A sponsor of a mutual fund is similar to the promoter of a company.
- The sponsor is the person who makes first investments.
- The sponsor contributes at least 40% of the net worth of the AMC.
- SEBI defines "Sponsor" as "any person who, acting alone or in combination with another body corporate, establishes a mutual fund".
- The sponsor forms a Trust, appoints the Board of Trustees, appoints an Asset Management Company and either directly or acting through the Trustees, appoints a custodian.

Example:

Mutual Fund	**Sponsor**
HSBC Mutual fund	HSBC Securities & Capital Markets (I) Pvt. Ltd.
IDFC Mutual fund	Infrastructure Development Finance Company Ltd.
ING Mutual fund	National Nederlanden Interfinance B.V.

5. What is an asset management company (AMC)?

The AMC is a company registered under the Companies Act, 1956 to act as the investment manager for the mutual fund. As investment manager it will manage the money of the mutual fund. This will done through a team of fund managers who it appoints.

50% of the directors of the AMC should be independent.

In India, all mutual funds (*read* AMC) have to be registered with SEBI before they launch any scheme.

Example:

Mutual Fund	Asset Management Company
Kotak Mutual fund	Kotak Mahindra Asset Management Co. Ltd.
Fidelity Mutual fund	Fidelity Fund Management Pvt. Ltd.
UTI Mutual fund	UTI Asset Management Pvt. Ltd.

6. Who are trustees? What are their functions?

Trustees are a "group of persons" having overall supervisory authority over the fund managers. They oversee the activities of the AMC and seek to ensure that all regulatory aspects are complied with. In essence, they are responsible for ensuring that corporate governance takes place.

As Trustees are the guardians of the unit holders' funds and assets, a Trustee has to be a person of high integrity and repute. Two-thirds of the Trustees must be independent persons, not associated with Sponsors in any capacity.

Trustees have the following functions.

- Enter into an investment management agreement with the AMC.
- Ensure that the fund's transactions are in accordance with the trust deed.
- Ensure that the AMC has proper checks and balances in

place and has appointed key personnel including fund managers and a compliance officer.

- Ensure that the AMC is managing the schemes independent of other activities and that the interests of the unit holders of one scheme are not compromised with those of other schemes.
- Furnish to SEBI on a half yearly basis, a report on the mutual fund's activities and a certificate stating that the AMC has been managing the schemes independently of other activities.

7. Who is a custodian?

A Custodian is generally a body corporate which holds the assets (Shares, bonds etc) of the mutual fund. Generally banks are custodian for the assets of mutual fund. They charge a fee for the services rendered and these are charged to the individual scheme.

Having a separate custodian is considered necessary so that the AMC can concentrate on its area of core competence, namely investment management.

Example:

Mutual Fund Scheme	**Custodian**
Morgan Stanley Growth Fund	J.P Morgan Chase Bank
Fidelity India Special Situations Fund	J.P Morgan Chase Bank
HDFC Infrastructure Fund	Citibank N.A.

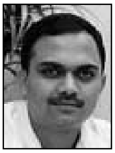
8. Who are fund managers? What is their role in mutual funds?

A fund manager works for an AMC.

He is the person who is entrusted with the responsibility of managing a fund scheme's money. Thus we could have different fund managers for different schemes of a mutual fund. Alternatively, one person can double as the fund manager of more than one scheme.

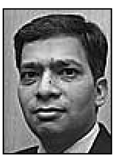
Best fund managers for the year 2008

EQUITY



No. 1
Prashant Jain
40, HDFC AMC

I believe in investing in good quality businesses. I use a mix of bottoms-up and top-down approach to identify the best companies to invest in.



No. 2
Krishna Sanghvi
34, Kotak MF

I prefer large cap and mid cap companies and invest for growth. I prefer companies with management capabilities.

No. 3
M. Venugopal,
37, Tata AMC

I try to identify good companies ahead of others, spot trends and depend on in-house research. We have a mix of top-down and bottoms-up approach.

Computer Age Management Services (CAMS) – is India's largest Registrar and Transfer Agent.

The fund manager takes the buy-sell-hold decision. He also decides on how much to invest in a particular sector or industry. While the Research Analyst identifies good companies and good industries to invest in, it is the fund manager's call as to whether to invest or not, and if so where, when and how much. Similarly when it comes to making a sale he uses the inputs of the research analyst to decide whether to sell or not, and if so where, when and how much.

9. Who are registrar and transfer agents? What is their role?

Registrar and Transfer Agents (RTA) are the institutions that maintain a registry of unit holders of a fund and other details (both statutory and non-statutory) pertaining to their unit ownership. RTA undertakes and executes all transactions such as purchase, redemption of a fund. They distribute dividend warrants to the unit holders and also provide the unit holders with annual statement and statutory information, among others.

10. What are the features of a mutual fund?

Features of mutual funds are as follows:

- Investors purchase units of a mutual fund scheme from the mutual fund itself rather than purchase it from other investors as in shares.
- Resources of like-minded people are pooled together and invested in the capital market.
- Units are purchased at Net Asset Value (NAV) per unit. Apart from this the investor has to pay any load that the mutual fund may impose.
- The fund is managed by professional investment managers.

- The investor is a co-owner in the assets of the scheme in which he invests. His share is his investment amount in proportion to the total unit capital of the scheme.
- Units can be sold back to the mutual fund itself, meaning the units have always got a market (buyer and seller).

11. What are the advantages of investing in mutual funds?

The following are some of the advantages of investing in a mutual fund:

a. **Professional management:** Mutual funds are managed by professionals who are trained in the science and art of investment management.

b. **Diversified portfolio:** An important rule of investment is to have a diversified portfolio. This would mean building an array of stocks which overall will perform well in all markets. Diversification is required in order to reduce risk. If an individual investor wants to build a diversified portfolio he will in today's market have to invest in about 7-10 stocks and make an investment of say Rs.500,000.

   However when he invests in a mutual fund he becomes a part owner of the mutual fund and so becomes a part owner of the fund's diversified portfolio. Hence by investing as small as sum as Rs.5,000 he gets a diversified portfolio in place.

c. **Economies of search:** Stock picking is not an easy affair. If an investor were to invest by himself he will have to do research into the economy, industry and company before investing. If hundreds of investors invest separately each will have to perform this research. By investing in a mutual fund the search is conducted by one entity alone (namely the mutual

Best fund managers for the year 2008

DEBT

No. 1
Pankaj Tibrewal, 29, Principal PNB AMC

My investment reflects a blend of large, mid and small cap companies. There is no market cap restriction. The focus is fully on bottoms-up stock picking.

No. 2
Satyabrata Mohanty, 35, Birla Sun Life AMC

My idea is to hunt for superior risk-adjusted returns. I follow a dynamic duration strategy. Depending on our view of the debt markets, asset allocation is decided between corporate bonds and government securities.

(Businessworld Issue 25 Feb-3 Mar 2008)

fund) thus saving huge research cost. This is referred to as economies of search.

d. **Economies of scale:** When individual investors invest brokers charge brokerage both on purchase and on sale. So is the case when they buy/sell on behalf of a mutual fund except that the brokerage charges are significantly less.

e. **Host of services:** Mutual funds have a variety of services which make them convenient. Example: SIP, SWP, STP, Online trading etc.

f. **Liquidity:** Mutual fund investments are at call, especially if they are open ended fund. This means that if you want your money back, you will just have to walk into a mutual fund and in 48 hours time get your money back. In the case of close ended fund listing options are available which implies that such schemes are traded in the market.

g. **Safer than direct investment in shares:** Diversified portfolio and professional fund management make mutual fund investment *prima facie* safer than direct investment in shares.

h. **Tax advantage:** The income of a mutual fund is not subjected to tax, whether income or capital gains.

12. What are the disadvantages of mutual funds?

The shortcomings of mutual fund investment are:

a. **Risky investment:** Irrespective of professional fund management and diversification, mutual funds still carry all the risks that are inherent to stock and debt market investment.

b. **No tailor made portfolio:** Mutual fund products are pooled investment vehicles. Hence they are not tailor made to suit the requirements of individual investors. This is where portfolio managers come in handy. They can structure investments according to your risk appetite.

c. **Costs:** Engaging professional managers carries a price. The loads that the mutual funds charge eat into your return. There are loads at the time of entry and loads at the time of exit. For example if the **NAV** of a scheme is Rs.20 and the load on entry is 2% you can buy the units at only Rs.20.40. Similarly exit loads shave off a part of your profits.

d. **No guaranteed return:** Returns are not guaranteed and mutual funds may generate negative returns during a fall in stock prices. Professional management is not a guarantee to success.

13. WHAT ARE THE PHASES OF EVOLUTION OF MUTUAL FUNDS IN INDIA?

Phase 1 – 1964 to 1987 – Growth of UTI: In 1963, the Unit Trust of India (UTI), considered as the grand daddy of the mutual fund industry, was established by an Act of Parliament and became India's first mutual fund.

Its first scheme, and for long one of the largest and most successful schemes, was Unit Scheme 1964. Its other attractive and innovative scheme was the ULIP (Unit Linked Insurance Plan) which was launched in the year 1971.

Phase 2 – 1987 to 1993 – Entry of Public sector funds: For 23 long years the UTI was the only choice for the investor. Things changed in 1987, when the Mutual Fund industry was opened up to the Public sector with the establishment of the State Bank of India Mutual fund. Six other public sector mutual funds quickly came into operation taking the tally to eight.

Phase 3 – 1993 to 1996 – Emergence of Private funds: In 1993, the Mutual Fund industry was opened up to the private players. Kothari Pioneer operating out of Chennai (then Madras) was the first such fund. For a long time it was the best performing fund. In 1994, foreign players were allowed to set shop without Indian partners. Morgan Stanley was the first foreign fund. Its emergence created quite a splash in the industry.

The Firsts... Public Sector Mutual Funds:

SBI Mutual fund,
PNB Mutual fund,
GIC Mutual fund,
LIC Mutual fund,
Canara Bank Mutual fund,
BOI Mutual fund,
Baroda Mutual fund,
Indian Bank Mutual fund.

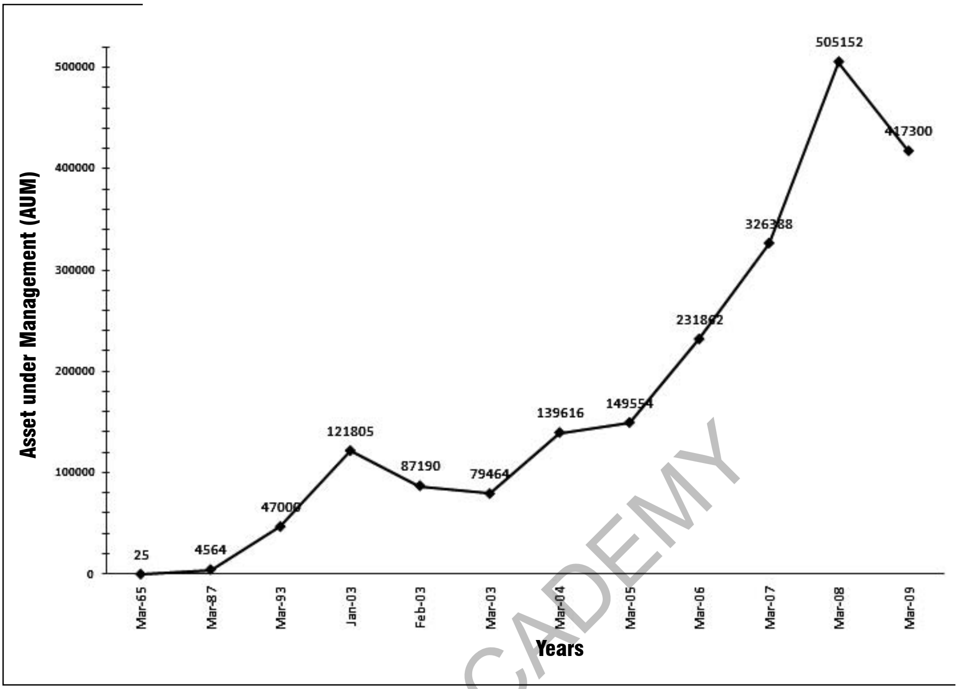
Phase 4 – 1996 to 1999 – Growth and SEBI regulations: Since 1996, the Indian mutual fund industry saw heightened activity and this called for greater regulations and controls in place. SEBI in 1996 came out with a regulation for governing mutual funds. Measures were taken both by SEBI to protect the investor and by the Government to enhance the returns through tax benefits.

Phase 5 – 1999 to 2004 – The Industry matures: In 2003, the UTI Act was repealed. This was to bring a level playing field for all fund players. Prior to that while every mutual fund came under the ambit of SEBI, UTI alone was outside its ambit; covered as it was by the UTI Act. Now the UTI also came under the same structure of sponsor-trustee-AMC and most importantly with SEBI as the umpire.

Phase 6 – 2004 onwards – Consolidation and Growth: The industry witnessed a spate of mergers and acquisitions. For example, Sun F&C Mutual Fund was taken over by Principal Mutual Fund. So was PNB Mutual Fund. Alliance Mutual fund was taken over by Birla Sun Life Mutual Fund. Now new players are entering the industry (Goldman Sachs, Bharati AXA, Edelweiss, Religare, etc.) and the industry is poised to grow further.

14. Who governs mutual funds in India?

Mutual funds in India are governed by the Securities and Exchange Board of India (SEBI) through the SEBI (Mutual Funds) Regulations, 1996 and by the Association of Mutual Funds in India (AMFI), a self regulatory organization.



Source : www.amfiindia.com

15. What is meant by asset allocation?

"Do not put all your money in one basket" is an old saying. But it is a saying which is very true. There is a need to spread one's money across different assets in order to diversify one's risks away. The decision on how much money to invest in each asset class is what is all about asset allocation. Mutual fund is one asset class.