

## Functions of the indian mutual fund industry

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**ABSTRACT:** Investment is a commitment of funds in real assets or financial assets. Investment involves risk and gain. In the present dynamic global environment, exploring investment avenues are of great relevance. Investment skills developed over a period of time are considerably influenced by experience and spadework carried out to arrive at conclusions. The success of an investment activity depends on the knowledge and ability of investors to invest, the right amount, in the right type of investment, at the right time. Real assets, being tangible material things, are less liquid than financial asset. Compared to financial assets, returns on real assets are more difficult to measure accurately due to the absence of broad, ready, and active market. Financial assets available to individual investors are manifold, having different concomitant benefits to choose from. All financial investments are risky but the degree of risk and return differ from each other. An investor has to use his discretion, which is an art acquired by learning and practical experience. The knowledge of financial investment and the art of its management are the basic requirements for a successful investor. Financial system comprises of financial institutions, services, markets and instruments, which are closely related and work in conjunction with each other. The history of new financial institutions and instruments developed in recent years, with the ostensible objective of modernizing the financial sector, is impressively long; Mutual Funds, Discount and Finance House of India, Money Market Mutual Funds, Certificate of Deposit, Commercial Paper, Factoring and Treasury Bills. Financial services through the network of elements serve the needs of individuals, institutions and companies. It is through these elements, the functioning of the financial system is facilitated. Over the years, the financial services in India have undergone revolutionary changes and had become more sophisticated, in response to the varied needs of the economy. The process of financial sector reforms, economic liberalization and globalization of Indian Capital Market had generated and augmented the interest of the investors in equity. But, due to inadequate knowledge of the capital market and lack of professional expertise, the common investors are still hesitant to invest their hard earned money in the corporate securities. The advent of mutual funds has helped in garnering the investible funds of this category of investors in a significant way.

Keywords: Investments; Mutual Fund; Finance House; Capital Market

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### INTRODUCTION

The idea of pooling money dates back to 1822, when groups of people in Belgium established a company to finance investments in national industries under the name of 'Societe Generale de Belgique' incorporating the concept of risk sharing. The institution acquired securities from a wide range of companies and practiced the concept of mutual fund for risk diversification. The word 'mutual' denoted something to be done collectively by a group of people with the common objective of having mutual faith and understanding among themselves. 'Fund' was used in monetary terms, to collect some money from the members for a common objective like earning profits with joint efforts. In 1822, King William I of Netherlands came up with a close-end fund. In 1860, this phenomenon spread to England. In 1868, the Foreign and Colonial Government Trust of London was formed, which was the real pioneer to spread risk of investors over a large number of securities and was considered as the Mecca of modern mutual funds. In 1873, Robert Fleming, established 'The Scottish American Trust'. Although, many nineteenth century British investment trusts invested in American stocks, the first American

investment trust was the close-end Boston Personal Property Trust created in 1893. In U.K., the accepting houses emerged as a major force in the business of investment management.

### **INDIAN PANORAMA**

The Indian capital market having a long history spanning over a century had passed through the most radical phase. The Indian Capital Market witnessed unprecedented developments and innovations during the eighties and nineties. One such development was the increased role the mutual fund industry played in financial intermediation. Mutual fund, as an institutional device, pools investor's funds for investment in the capital market under the direction of an investment manager. Mutual funds bridge the gap between the supply and demand for funds in the financial market. In India, the need for the establishment of mutual funds was felt in 1931 and the concept of mutual fund was coined in 1964, by the far-sighted vision of Sri T.T.Krishnamachari, the then finance minister. Taking into consideration the recommendations of the Central Banking Enquiry Committee and Shroff Committee, the Central Government established Unit Trust of India in 1964 through an Act of Parliament, to operate as a financial institution as well as an investment trust by way of launching UTI Unit Scheme 64. The overwhelming response and the vast popularity of UTI Unit Scheme 64 and the Master share Scheme in 1986 attracted the attention of banks and other financial institutions to this industry and paved the way for the entry of public sector banks. By the end of 1986-87, UTI had launched 20 schemes mobilizing funds amounting to Rs.4,56,500 crores. Since then, the mutual funds have established themselves as an alternative investment vehicle and are now an integral part of the Indian financial system.

In 1987, the public sector banks and insurance companies were permitted to set up mutual funds. Accordingly, the LIC and GIC and six public sector banks initiated the setting up of mutual funds, bringing out a new era in the mutual fund industry. Mutual fund reforms attempted for the creation of a competitive environment by allowing private sector participation. Since 1991, several mutual funds were set up by private and joint sectors. Many private mutual funds opted for foreign collaboration due to the technical expertise of their counterparts and past track of success. On February 19, 1993, the first batch of 12 private sector mutual funds was given in-principle approval by the Securities Exchange Board of India (SEBI). The erstwhile Kothari Pioneer Mutual fund (now merged with Franklin Templeton) was the first fund established in July 1993 in the private sector.

### **SIGNIFICANCE OF THE STUDY**

Mutual funds play a crucial role in the economic development of the respective countries. The active involvement of mutual funds in the economic development can be seen by their dominant presence in the money and capital markets world over. Their presence is, however, comparatively stronger in the economically advanced countries.

The role of the mutual funds in the form of financial remediation, by way of resource mobilization, allocation of resources, and development of capital markets and growth of corporate sector is very conspicuous. Mutual funds also play an important role in the stock market by way of ensuring stability as supplier of large resources and through steady absorption of floating stocks. Mutual funds are well known for their benefits in the following forms to its investors:

- [1] Professional expertise in buying and selling of units;
- [2] Professional management of securities transactions;
- [3] Opportunity to hold wide spectrum of securities;
- [4] Long-term planning by fund managers;
- [5] Safety of funds;
- [6] Spreading of risk;

- [7] Freedom from stress and emotional involvement;
- [8] Automatic reinvestment of dividends and capital gains;
- [9] Dissemination of information on the performance of the mutual funds, schemes, fund managers and,
- [10] Investor protection.

Emergence of mutual funds in the Indian scenario is a product of constraints on the banking sector to tap the fruits of the capital market and the reluctance of the investors to take a direct plunge in complex and erratic capital market operations. Mutual fund entered the arena of this service sector in an admirable manner. The IMFI is one among the top 15 nations in terms of assets under management, which has crossed USD 100 billion. As a globally significant player the IMFI is attracting a bigger chunk of household investments and is expected to witness five to six times growth in the next seven to eight years. It is expected that the industry's AUM may grow to USD 500-600 billion by 2015 as more global players are planning and ready to set up asset management businesses in India.

#### **NEED FOR THE STUDY**

India's savings rate is over 23 percent, which is one of the highest in the world. In order to accelerate economic development of our country, it is not only necessary to increase the rate of savings but also to improve the holding pattern of such savings. Savings held in the form of currency or physical assets either remain idle or kept unproductive or wasted. The Government's steps to channel the financial savings are one of the major contributions for the rapid economic growth.

The rate of conversion of household savings into investment in our country is very low. The percentage of household savings that flew into the capital market in India is as poor as 7 percent, as against 25 percent in the U.S.A. and 19 percent in Japan. As the household sectors share is much higher in the country's savings, it is of utmost importance to show a right path for their deployment. The Indian household sector is characterized by a tendency to avoid risk as they lack the mental readiness to absorb the shocks of the volatile capital market. Hence, to attract the surplus funds possessed by this sector into the capital market, institutional intermediaries are required.

The Indian household sectors' investment in mutual funds made a greater beginning in the second half of the eighties. Though apparently mutual funds were intended to cater to the needs of the retail investors, there had been no sufficient response from them. Mutual funds are supposed to be the best investment vehicle for small investors and hence there is a need to find out investors' perceptions and factors influencing their decisions. So, there is a dire necessity to identify how far mutual funds satisfy the twin aspirations of the investors (steady appreciation of unit value and consistent return on investment).

In the year 2001, despite a long history, assets of mutual funds in India constituted less than 5 percent of Gross Domestic Product, which is very low compared to 25 percent in Brazil, and 33 percent in Korea. This is perhaps due to the reason that the industry has not won investors confidence to attract a growing share of household's financial savings. The IMFI is still not able to establish its worthiness among retail investors as a clearly preferred vehicle of investment for their savings even after forty years of its existence.

Today, more and more private sector mutual funds are coming into the foray. An average investor is unable to take a decision as to which bandwagon should he hop on to. As household sector's share is much larger in the country's savings it is utmost essential to guide their deployment in the right direction. Thus, there is a need for the present study to bring to light the performance of the mutual funds, which can help the retail investors to make valued judgment in terms of deploying their savings to the capital market through the mutual fund vehicle. With the growing institutionalization, retail investors are gradually keeping out of the primary and secondary market, and looking forward to mutual funds for their investments.

Among the mutual funds, it is expected that debt oriented schemes will continue to dominate the mutual fund industry satisfying the needs of yield, security and liquidity fairly well besides being attractive from the tax point of view.

While equity oriented schemes will gain more significance in future, their popularity will depend on the conditions of the stock market and the kind of tax relief accorded to them. Hence, it is of utmost importance to study the performance of growth schemes of mutual fund industry, which is a near substitute for direct investment in shares. Analysis of risk-return of schemes and its relationship with the market will provide information on the performance of sample schemes, fund managers ability in selecting and timing security related transactions in the present scenario of multitudinous mutual fund schemes.

### **OBJECTIVES OF THE STUDY**

This research work is undertaken with the following objectives:

- To appraise the performance of mutual fund industry in India under the regulated environment.
- To study the relationship between the performance of market index with that of the growth schemes.
- To study the factors influencing choice of investment in mutual funds by the fund managers.
- To study the attitude of investors and brokers towards investment in mutual funds.

### **HYPOTHESES**

Based on the above objectives, the following hypotheses were set: Hypothesis 1: There is no significant difference among the performance evaluation tools as suggested by Sharpe, Treynor and Jensen.

Hypothesis 2: Index returns and scheme returns are not significantly related.

Hypothesis 3: Past performance of the scheme does not have any significant relationship with that of current performance.

Hypothesis 4: Investment decisions are not significantly influenced by the profile of investors.

Hypothesis 5: Profile of investors does not have any significant impact on the criteria of selecting mutual fund scheme.

Hypothesis 6: There is no domination of attitudinal difference between the opinions of investors towards investment in mutual funds.

Hypothesis 7: There is no significant difference between the opinions of investors, brokers and fund managers with regard to the factors influencing the choice of mutual fund and scheme.

### **SCOPE OF THE STUDY**

This research work attempts to evaluate the performance of mutual fund industry in India under the regulated environment after the introduction of the SEBI (Mutual Funds) Regulations 1996 enforcing uniformity in rules and regulations. Performance evaluation is restricted to seven growth schemes launched in 1993 when the industry was opened for private sector and the industry brought under the regulated environment for the first time by passing the SEBI (Mutual Funds) Regulations 1993. Performance in terms of NAV of growth schemes with growth option alone is studied from the angle of risk and return in comparison with the benchmark (BSE 100) index from April 1998 (a year after the introduction of comprehensive regulations) to March 2006. All the seven selected schemes were initially launched as close-end and were later converted into open-end. To identify the perception of investing public and financial intermediaries, an opinion survey of investors, brokers and fund managers of sample schemes were carried out.

### **OPERATIONAL DEFINITIONS AND CONCEPTS**

**Mutual Fund** is a fund established in the form of a trust by a sponsor to raise money by the trustee through the sale of units to the public under one or more schemes for investing in securities in accordance with the

SEBI regulations.

**Mutual fund scheme** refers to the MF products launched representing a category with specific objective and varied options. A scheme can

belong to open or close-end type of operation. The objective of the scheme can relate to any category like income, growth, balanced, money market and equity linked savings scheme.

**Open-end Funds** are schemes of a mutual fund offering units for sale on a continuous basis directly from the fund and does not specify any duration for redemption or repurchase of units.

**Net Assets Value** is the current market worth of a mutual fund scheme. Calculated on a daily basis considering total assets and any accrued earnings, after deducting liabilities; the remainder is divided by the number of units outstanding. NAV is considered as the most reliable indicator of mutual fund performance.

**Unit** means the share of holding of an investor in a mutual fund scheme. Each unit represents one undivided share in the assets of a scheme.

**Unit-holder** is a participant in a mutual fund scheme.

**Growth Schemes** invest primarily in shares and also might hold fixed-income securities in a smaller proportion.

**Growth Option** of a mutual fund scheme is an option for long term growth of resources mobilized as it invests primarily in shares with significant growth potential.

#### **LIMITATIONS OF THE STUDY**

The limitations of this study are as follows:

- i. Since the study is mostly based on the secondary data, the shortcomings of the use of secondary data are inevitable.
- ii. Performance evaluation of the scheme is based only on the NAV of the growth category schemes with growth option alone.
- iii. Brokerage commission, entry load, exit load and taxes were not considered.
- iv. Based on the availability of data, industry analysis has been carried only from 1997-98 to 2005-06 while performance analysis of sample schemes relates to the period 1998-99 to 2005-06.
- v. The present study does not cover the impact of mergers and takeovers of the sample schemes.
- vi. Opinion survey of investors and brokers were restricted to Kovai Investors Association and Coimbatore Stock Exchange.

**CONCLUSION:** The hallmark of any mutual fund is to outperform the market both in rising and falling markets besides ensuring benefits of diversification. Of the sample schemes, can growth Plus Scheme, Franklin India Blue chip scheme, Franklin India Prima Scheme, HDFC Capital Builder Scheme and SBI Magnum Multiplier Plus scheme outperformed the market in terms of absolute returns and Sharpe index. While Only SBI Magnum Multiplier Plus scheme Outperformed market in terms of neither Treynor index and also had positive Jensen's alpha. All the three risk-adjusted performance measures showed significant agreement in ranking the sample schemes. Of the sample schemes studied, SBI Magnum Multiplier Plus Scheme topped the list in all the three portfolio performance models. All the sample schemes (except LIC MF Equity Scheme) ensured positive returns due to stock selection skills of fund managers. The variance explained by the market was high in the case of SBI Magnum Multiplier Plus scheme. The market performance had a significant positive influence on scheme performance in case of all the schemes covered under the study. The present NAV is positively significantly correlated with that of its past NAV but the impact got reduced as the time lag increased. The survey of investors'

perception revealed that, profile of investors has a significant impact on the investor's decisions relating to investments and particularly mutual fund investments. Investors had high preference for bank deposits while brokers preferred equity shares. Regular income, safety, profitability and tax benefits motivated investors in the choice of scheme. Private sector joint venture (predominantly)

Indian mutual funds were highly preferred by both investors and brokers. Both investors and brokers prefer growth schemes followed by income schemes. Brokers / agents were the main source of information about mutual funds. According to investors, the most important benefit of mutual funds was profitability while portfolio diversification, liquidity of investment and professional management were very important for brokers. Quality of service was the most important determinant of success for mutual fund according to investors, brokers and fund managers. Goodwill was the main criterion of choosing mutual fund organization for all the three categories of respondents. For investors, capital appreciation influenced the choice of mutual fund scheme. For brokers, return on investment and safety affected the choice of mutual fund schemes. For fund managers, capital appreciation, liquidity and portfolio manager's background were important criteria of choosing mutual fund schemes. Very few investors were fully satisfied while majority were moderately satisfied with the performance, opportunities provided, and services offered by the IMFI. Investors and fund managers agreed that, investing in mutual funds were less risky compared to shares. Brokers and fund managers highly agreed that mutual funds were more suitable to small investors who were otherwise hesitant of entering into capital market. Fund managers viewed that mutual funds have the ability to weather the market fluctuations and accepted that investing in funds is much better in terms of returns than depositing money in banks. Brokers opined that risk and return characteristics of Indian mutual funds were not in conformity with their stated objectives.

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