CHAPTER 04 – MUTUAL FUNDS

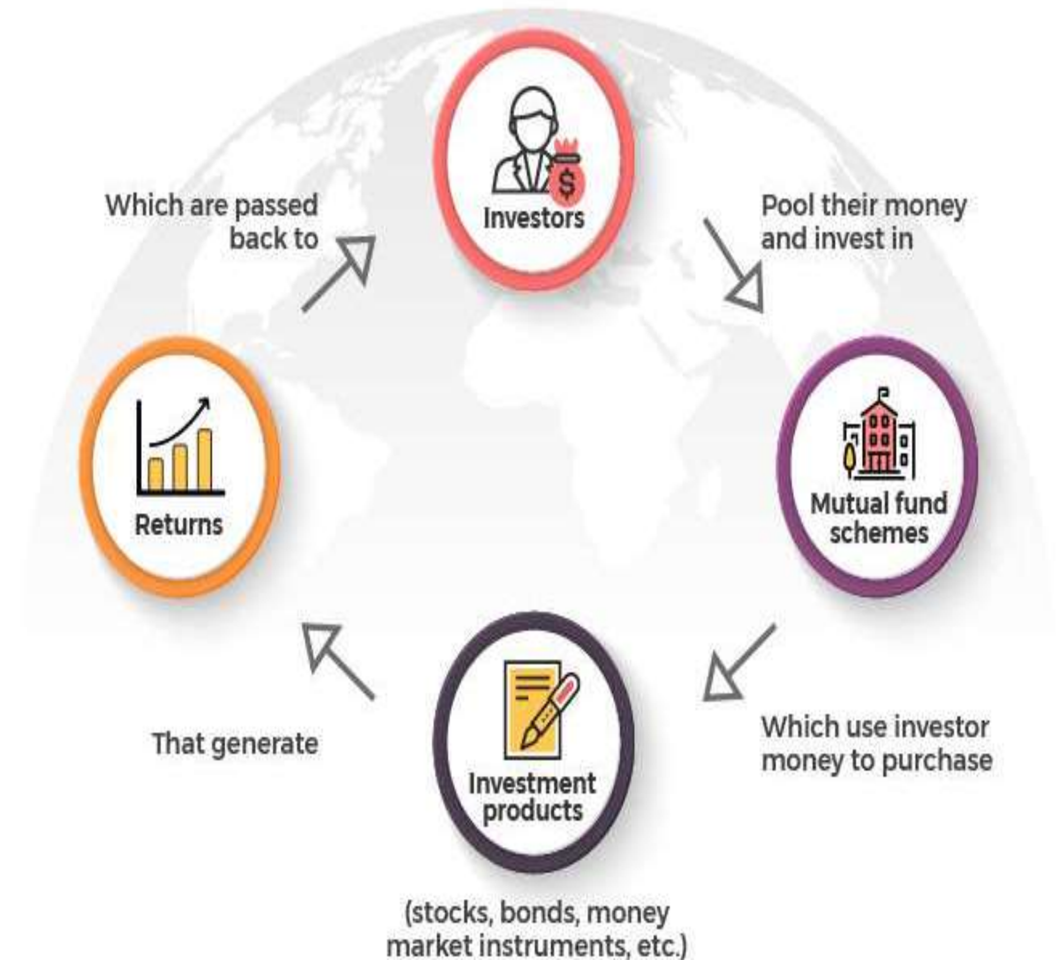
MUTUAL FUNDS

- Meaning –

A mutual fund is a pool of money collected from public to be invested to achieve specific investment objective of the investor.

- Definition –

Praveen N. Shroff defines a mutual fund as, “a portfolio of stock market shares and other financial instruments built with funds collected from small investors, whose concern is security of investment”.

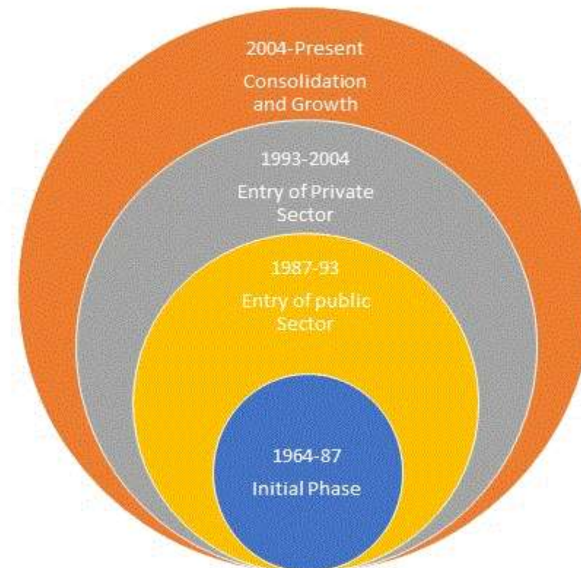


- ‡ Mutual funds fill the gap of investment expertise between investor's funds and corporate securities.
- ‡ Mutual funds form a professional interface between the small investors and the investment markets.
- ‡ In India, mutual funds are registered under the Indian Trust Act.
- ○ Importance (Significance/Benefits) of mutual funds –

1. Suitable for small investors
2. Risk management
3. Wholesale investment
4. Investor education
5. Investment research
6. Liquidity of stock market
7. Development of money market/capital market
8. Savings mobilization
9. Investor protection
10. Evaluation of investment
11. Transparent portfolio
12. Benefit of diversification
13. Tax implication
14. Liquidity of investment
15. Market efficiency
16. Small amount of investment
17. Easy access
18. A wide choice of investment
19. Benefit of investment research
20. Switching between schemes

GROWTH OF MUTUAL FUNDS IN INDIA

- I Stage – Establishment of Unit Trust of India (UTI)
- II Stage – Mutual funds by Public Sector Banks
- III Stage – Public and Private Mutual funds with the participation of Foreign Funds



I STAGE – ESTABLISHMENT OF UTI

- UTI was bought into existence by passing legislation in the parliament called Unit Trust of India Act, 1964.
- Mutual funds are called unit trusts in the UK.
- First mutual fund scheme was Unit Scheme 1964 (US 1964), which had monopoly from 1964 to 1987.
- In 1966-67, UTI introduced the Reinvestment Plan by which the dividend was converted into units and credited to the account of the unit holder.
- In 1971, Unit Linked Insurance Plan was introduced.
- Other schemes introduced were - Children Gift Growth Fund, Master Share Series and Monthly Income Schemes etc.,

II STAGE – MUTUAL FUNDS BY PUBLIC SECTOR BANKS

- In 1987, State Bank of India broke the monopoly of UTI.
- Later, Canara Bank started Canbank Mutual Funds Scheme, Punjab National Bank (Principal PNB Schemes) and Insurance companies like LIC launched their schemes.

III STAGE – PUBLIC AND PRIVATE MUTUAL FUNDS WITH THE PARTICIPATION OF FOREIGN FUNDS

- From 1993, the competitive era began in the mutual fund industry in India.
- Foreign funds started to tie up with Indian public sector and private sector participation.
- The above tie-ups are categorized into the following groups –

1. Term lending institutions – IDBI ; ICICI tied up with Prudential Inc., of the USA
2. Insurance companies – LIC and General Insurance Corporation
3. Private sector – Birla's, TATA's, Reliance, Sundaram Finance, HDFC, Kotak Mahindra etc.,
4. Foreign funds – Alliance, DSP-Merrill Lynch, Fidelity and franklin Templeton

TYPES OF MUTUAL FUNDS

Portfolio based classification

1. Growth-oriented schemes
2. Income-oriented schemes
3. Income and growth schemes (Balanced Funds)
4. Tax planning schemes [Equity Linked Savings Scheme]
5. Index funds
6. Gilt funds
7. Money market scheme
8. Theme funds
9. Fund of funds
10. Contra fund
11. Inverse index fund
12. Others
13. Systematic investment plan

Operational classification

1. Open-ended schemes
2. Close-ended schemes
3. Interval schemes

PORTFOLIO BASED CLASSIFICATION

- Growth-oriented schemes -
  - funds are invested in the equity shares of companies
  - aim is to earn capital gains in the medium to long term
  - e.g., SBI Magnum Equity Fund, Birla Advantage Fund, IDBI – Principal Growth Fund, Fidelity Equity Fund
  - risk and return are very high
- Income-oriented schemes -
  - funds are invested in income yielding securities like bonds, debentures, govt. securities, commercial paper and other money market instruments
  - e.g., HDFC Income Fund, Kotak Mahindra Dynamic – Income Scheme

CONTINUED…

- Income and growth schemes (Balanced Funds)
  - partial investment in equity shares and the remaining money in debt related securities
  - thereby deriving income in the form of interest on debt securities and in the form of capital gains & dividend on the equity
  - there is a balance between the risk and return
  - e.g., Alliance 95' Fund, Prudential ICICI Balanced Fund and PNB-Balanced Growth Fund
- Tax planning schemes [Equity Linked Savings Scheme]
  - came into existence in 1992
  - investors are eligible for tax benefits
  - amount invested in ELSS is eligible for tax deduction under 80C up-to Rs. 1lakh
  - e.g., Birla Equity Plan, Sundaram Tax Saver and HDFC Long Term Advantage Fund

CONTINUED…

- Index funds
  - funds are invested in the shares included in a share index like Sensex of BSE or Nifty of NSE
  - returns are related to the movement in the index
  - Indian Index Funds prefer S&P CNX Nifty Index
  - e.g., HDFC Index Fund, IDBI-Principal Index Fund, Franklin India Index Fund
- Gilt funds
  - funds are invested in totally risk-free securities
  - funds are invested in Govt. Bonds and Treasury Bills issued by the Central Govt.
  - e.g., UTI-G-Sec Fund, HDFC Gilt Fund

CONTINUED…

❑ Money market scheme

- funds raised here aim at liquidity of investment
- investment is made in Treasury bills, Commercial paper, Certificate of Deposit and Call-Money
- corporates park their temporary funds in this scheme
- e.g., Ing-Vyasa Liquid Fund, DSP-ML Liquidity Fund, Reliance Liquid Fund and IDBI Cash Management Fund

❑ Theme funds

- also known as Focus Funds or Sectoral Funds
- funds are invested in the equity of the companies belonging to the same industry
- industry selected is a high growth one like software industry, pharmaceutical industry, FMCG industry etc.,
- funds have high risk-return profile
- e.g., Prudential ICICI FMCG Fund, Birla IT Fund, Alliance Basic Industry Fund

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❑ <u>Fund of funds</u>

- funds are invested in the units of the same mutual fund or in the units of other mutual funds
- carries diversification of investment
- has a disadvantage of expenses being incurred twice
- e.g., Franklin Templeton India Life Stage Fund of Funds

❑ <u>Contra fund</u>

- funds are invested in the equity shares of such companies whose true worth has not been realized by the stock market and their share prices are far below their real worth
- investments are made only after conducting a detailed research about all the companies
- e.g., HDFC Core & Satellite Fund, UTI Contra Fund and SBI Magnum Contra Fund

CONTINUED…

- Inverse index fund
  - investment of money is in the shares having a negative beta
  - certain shares always move in the opposite direction to the movement in the market
  - when the market moves up, the prices of these shares go down
  - when the market is moving down, these shares appreciate in their value
  - such funds are advantageous, when the stock market is undergoing a prolonged phase of depression
- Others
  - the other funds are Emerging Opportunities Fund, Emerging Technology Fund etc.,

CONTINUED…

- Systematic investment plan

- through this mode, the investor invests a fixed amount every month in a particular scheme
- similar to a recurring bank deposit
- when Net Asset Value is less, the investor will receive more number of units (as in a declining market)
- when the market is booming, he gets less number of units, but the value of his investment goes very high because of higher NAV

OPERATIONAL CLASSIFICATION

❑ <u>Open-ended schemes</u>

- these schemes do not have any fixed maturity
- initially, the units are sold by way of an offer document at the face value
- fixed percentage of management fee on the face value is charged
- once the issue closes, the mutual fund buys and sells the units continuously based on the NAV
- selling agents and distributors are used for the sale of units of investors
- e.g., US- 1964 of UTI, SBI Magnum Equity Fund, UTI-Master Plus 91
- in the USA, open-ended funds are called mutual funds
- in the UK, they are called Unit Trusts
- in India, both open-ended schemes and close-ended schemes are called mutual funds

FEATURES OF OPEN-ENDED SCHEMES

1. No predetermined period of maturity
2. Changing amount of capitalisation or corpus
3. No restriction on entry
4. No restriction on exit
5. No lock-in period
6. Redemption
7. Income generation
8. No listing on the stock exchange
9. Part of investment in liquid assets
10. NAV computation everyday
11. Popularity

NOTE:

- ✓ **Entry load** - the amount or fee charged from an investor while entering a scheme or joining the company as an investor
- ✓ **Exit load -** a fee or an amount charged from an investor for **exiting** or leaving a scheme or the company as an investor

CLOSE-ENDED SCHEMES

- these schemes have a fixed maturity
- after the initial offer of the units, the mutual funds does not buy or sell the units
- only on the date of maturity, the mutual funds buy the units back from the unit-holders
- before that, these units are listed on stock exchanges
- investors can buy and sell the units on the stock exchange using the services of the brokers
- close-ended schemes are known as Investment Companies in the USA and Investment Trusts in UK
- e.g., UTI – Master Equity Plan-91, LIC-Mutual Fund-Dhanavarsha

FEATURES OF CLOSE-ENDED SCHEMES

1. Pre-determined date of redemption
2. Fixed capitalisation
3. Lock-in period
4. Listed on stock exchanges
5. No direct sale/purchase by mutual fund
6. NAV computation every week

INTERVAL SCHEMES

- here, units are listed on the stock exchanges
- in addition, mutual funds also sells and repurchases the units at the NAV based price
- e.g., UTI – Mastershare 1986