MUTUAL FUNDS : A SOUND INVESTMENT TOOL

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ABSTRACT

A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. These collective funds, referred to as Assets Under Management or AUM, are then invested by an expert fund manager appointed by a mutual fund company called Asset Management Company or AMC. Mutual funds reduce risk and provide better returns. The paper seeks to explain the concept of investment and mutual fund, trace the history and growth of mutual funds industry in India and get an insight into the various benefits of investing in a large variety of mutual fund schemes. It also reveals about the different entities involved in the organization of a mutual fund. The paper will help investors to develop an understanding of mutual funds as a sound investment tool.

Keywords: Mutual Funds, Investment, Assest Management, Investment tool.

INTRODUCTION

Of late, mutual funds have become a hot favourite of millions of people all over the world. The driving force of mutual funds is the safety of the principal guarantee, plus the added advantage of capital appreciation together with the income earned in the form of interest or dividend. People prefer Mutual Funds to bank deposits, life insurance and even bonds because with a little money, they can get into the investment game. One can own a string of blue chips like ITC, TISCO, Reliance, etc., through mutual funds. Thus mutual funds act as a gateway to enter into big companies hitherto inaccessible to an ordinary investor with his small investment. An investment is an operation which upon thorough analysis promises safety of principle and a satisfactory rate of return. Operations not meeting these requirements are speculative. "Investment is most prudent when it is most business like" – Benjamin Graham.

Daniel Myer has enumerated the three most timeless investment principles where he emphasizes on (1) Investing with a margin of safety: Margin of safety is the principle of buying a security at a significant discount to its intrinsic value, which is thought to not only provide high- return opportunities, but also to minimize the downside risk of an investment. In simple terms, Graham's (father of value investing) goal was to buy assets worth $1 for $0.50. He did this very, very well. To Graham, these business assets may have been valuable because of their stable earning power or simply because of their liquid cash value. It wasn't uncommon, for example, for Graham to invest in stocks where the liquid assets on the balance sheet (net of all debt) were worth more than the total market cap of the company (also known as "net nets" to Graham followers). This means that Graham was effectively buying businesses for nothing. While he had a number of other strategies, this was the typical investment strategy for Graham. This concept is very important for investors to note, as value investing can provide substantial profits once the market inevitably re-evaluates the stock and ups its price to fair value. It also provides protection on the downside if things don't work out as planned and the business falters. The safety net of buying an underlying business for much less than it is worth was the central theme of Graham's success. When chosen carefully, Graham found that a further decline in these undervalued stocks occurred infrequently. While many of Graham's students succeeded using their own strategies, they all shared the main idea of the "margin of safety." (2) Expect volatility: He advised to expect volatility and profit from one's investment, investing in stocks means dealing with volatility. Instead of running for the exits during times of market stress, the smart investor greets downturns as chances to find great investments. Graham illustrated this with the analogy of "Mr. Market," the imaginary business partner of each and every investor. Mr. Market offers investors a daily price quote at which he would either buy an investor out or sell his share of the business. Sometimes, he will be excited about the prospects for the business and quote a high price. At other times, he is depressed about the business's prospects and will quote a low price. Because the stock market has these same emotions, the lesson here is that you shouldn't let Mr. Market's views dictate your own emotions, or worse, lead you in your investment decisions. Instead, you should form your own estimates of the business's value based on a sound and rational examination of the facts. Furthermore, you should only buy when the price offered makes sense and sell when the price becomes too high. Put another way, the market will fluctuate - sometimes wildly - but rather than fearing volatility, use it to your advantage to get bargains in the market or to sell out when your holdings become way overvalued.

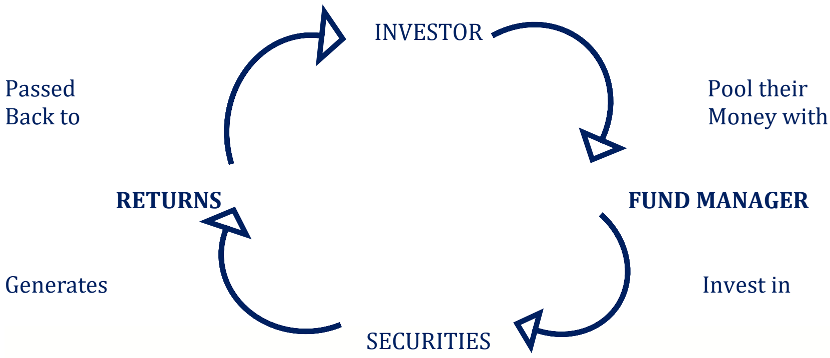
(3) Know what kind of investor you are: He wants the investor to know exactly the category they fit into: Graham advised that investors know their investment selves. To illustrate this, he made clear distinctions among various groups operating in the stock market. Active Vs. Passive Graham referred to active and passive investors as "enterprising investors" and "defensive investors." You only have two real choices: The first is to make a serious commitment in time and energy to become a good investor who equates the quality and amount of hands-on research with the expected return. If this isn't your cup of tea, then be content to get a passive, and possibly lower, return but with much less time and work. Graham turned the academic notion of "risk -return" on its head. For him, "Work = Return". The more work you put into your investments, the higher your return should be. If you have neither the time nor the inclination to do quality research on your investments, then investing in an index is a good alternative. Graham said that the defensive investor could get an average return by simply buying the 30 stocks of the Dow Jones Industrial Average in equal amounts. Both Graham and Buffett said that getting even an average return - for example, equaling the return of the S&P 500 - is more of an accomplishment than it might seem. The fallacy that many people buy into, according to Graham, is that if it's so easy to get an average return with little or no work (through indexing), then just a little more work should yield a slightly higher return. The reality is that most people who try this end up doing much worse than average. In modern terms, the defensive investor would be an investor in index funds of both stocks and bonds. In essence, they own the entire market, benefiting from the areas that perform the best without trying to predict those areas ahead of time. In doing so, an investor is virtually guaranteed the market's return and avoids doing worse than average by just letting the stock market's overall results dictate long-term returns. According to Graham, beating the market is much easier said than done, and many investors still find they don't beat the market. Speculator Vs. Investor: Not all people in the stock market are investors. Graham believed that it was critical for people to determine whether they were investors or speculators. The difference is simple; an investor looks at a stock as part of a business and the stockholder as the owner of the business, while the speculator views himself as playing with expensive pieces of paper, with no intrinsic value. For the speculator, value is only determined by what someone will pay for the asset. To paraphrase Graham, there is intelligent speculating as well as intelligent investing - just be sure you understand which you are good at.

“All intelligent investing is value investing” – Charlie Munger

CONCEPT OF MUTUAL FUND

A Mutual Fund is a trust that pools the saving of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized are shared by its unit holders in proportion to the number of units owned by them. The flow chart below describes broadly the working of a mutual fund.

INVESTOR



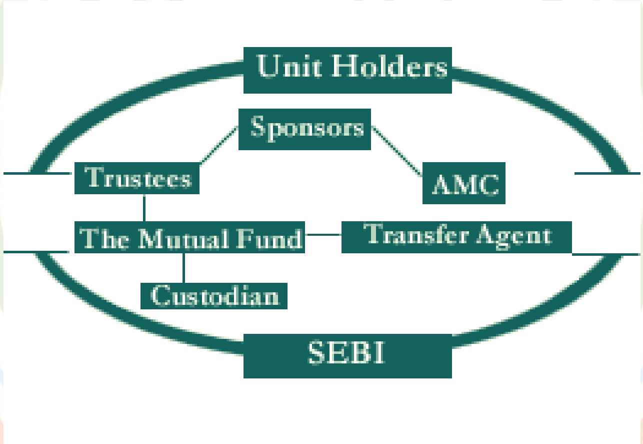
Mutual Funds work on the principle of small drops of water make a big ocean. For instance, if one has Rs.1000/- to invest, it may not fetch very much on its own. But, when it is pooled with Rs.1000/- each from a lot of other people, then one could create a "big fund" large enough to invest in wide varieties of shares and debentures on a commanding scale and thus, enjoy the economies of large scale operations. Hence, a mutual fund is nothing but a form of collective investment. It is formed by the coming together of a number of investors who transfer their surplus funds to a professionally qualified organization to manage it. To get the surplus funds from the investors, the fund adopts a simple technique. Each fund is divided into a small fraction called units of equal value. Each investor is allocated units in the proportion to the size of his investment. Thus every investor, whether big or small, will have a stake in the fund and can enjoy the wide portfolio of the investment held by the fund. Hence, mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emerged as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk. The Securities and Exchange Board of India (MF) Regulations 1993 defines a Mutual Fund as "a fund established in the form of a trust by a sponsor, to raise money by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations."

ORIGIN OF MUTUAL FUNDS

The origin of the concept of mutual fund dates back to the very dawn of commercial history. It is said that Egyptians and Phoenicians sold their shares in vessels and caravans with a view to spreading the risk attached with these risky ventures. However, the real credit of introducing the modern concept of mutual fund goes to the Foreign and Colonial Government Trust of London established in 1868. Thereafter, a large number of close – ended mutual funds were formed in the USA in 1930's followed by many countries in Europe, the Far East and Latin America. In India, mutual funds gained momentum only in 1980, though it began in the year 1964 with the Unit Trust of India launching its first fund, the Unit Scheme 1964. In India the only mutual fund operating for a long time since 1964 was the UTI. It is an open ended mutual fund, whose units can be sold and repurchased at any time. It is in the public sector engaging a monopoly position and some unique tax benefits such as exemption from income tax of its entire income. Although the UTI has operated a number of schemes linked to insurance and gifts, and some tax benefits, income declared by it to unit holders is not subject to any tax deduction at source and is exempt from income tax upto a limit. UTI was alone in the field until 1987. Since 1995-96, there is a tax deducted at source (TDS), if the annual income is more than Rs.10,000/. Mutual Funds have been set up since 1987 by the public sector banks following an amendment to the Banking Regulation Act in 1983, which empowered the RBI to permit the banks to carry on non-banking business such as leasing, mutual funds, etc. under section 6 of this act. Since then, the State Bank of India, Canara Bank, Punjab National Bank and some other nationalized banks have set up their own mutual funds. The permission given to private sector funds including foreign fund management companies (most of them entering through joint ventures with Indian promoters) to enter the mutual fund industry in 1993, provided a wide range of choice to investors and more competition in the industry. Private funds introduced innovative products, investment techniques and investor – servicing technology. By 1994-95, about 11 private sector funds had launched their schemes. The mutual fund industry witnessed robust growth and stricter regulations from the SEBI after the year 1996. The mobilization of funds and the number of players operating in the industry reached new heights as investors started showing more interest in mutual funds. Investor's interest was safeguarded by SEBI and the Government offered tax benefits to the investors in order to encourage them. SEBI (Mutual Fund) Regulation 1996 was introduced by SEBI that set uniform standards for all mutual funds in India. The Union Budget in 1999 exempted all dividend incomes in the hands of investors from income tax. Various Investor Awareness Programmes were launched during this phase, both by SEBI and AMFI, with an objective to educate investors and make them informed about the mutual fund industry. In February 2003, the UTI Act was repealed and UTI was stripped of its Special legal status as a trust formed by an Act of Parliament. The primary objective behind this was to bring all mutual fund players on the same level. UTI was re-organised into two parts : (a) The Specified Undertaking (b) The UTI Mutual Fund. Presently Unit Trust of India operates under the name of UTI Mutual Fund, the largest player in the industry.

ORGANISATION OF A MUTUAL FUND

There are many entities involved in the organizational set up of a mutual fund and the diagram below illustrates the same:



Sponsors are any body corporate which initiates the launching of a mutual fund. It is this agency which of its own, if eligible, or in collaboration with other body corporate complies the formalities of establishing a mutual fund. The sponsor should have a sound track record and experience in the relevant field of financial service for a minimum period of 5 years. SEBI ensures that sponsors should have professional competence, financial soundness and general reputation. Every mutual fund shall be registered under the said regulations and it is the sponsor who files an application. A trustee is a person who holds the property of mutual fund trust for the benefits of the unit holders. Once the mutual fund trust is formed, the role of sponsor virtually becomes nil. The trustees are to perform the duties: To manage the mutual fund in accordance with the laws, regulations, directions and guidelines issued by SEBI, Stock Exchanges and other governmental and regulatory agencies. To collect income due to be paid in respect of the schemes of mutual fund. Asset Management Company (AMC) is a body engaged to run the show of mutual fund. It is body corporate whose Memorandum and Articles of Association are to be approved by the SEBI. The sponsor or the trustees appoint AMC to manage the affairs of the mutual fund. The AMC takes reasonable steps and exercise due diligence to ensure that investments of schemes are as per the provisions of the regulations, submits returns to the trustees regularly, appoint the custodian, registrar and share transfer agents. In a mutual fund depending upon its size there is substantial work involved for managing the scripts bought from the market. SEBI requires that each mutual fund shall have a custodian who is responsible for such a work. To sum up, the assignment of custodian are to ensuring delivery of scripts only on receipt of payment and payment only upon receipt of script, regular reconciliation of assets to accounting records, timely resolution on discrepancies and failures and getting property registered or recorded. The transfer agent handles sales and redemptions of fund shares, maintains shareholder records, computes the NAV daily and handles dividend and capital gains distributions. The transfer agent is usually a bank or trust company.

TYPE OF MUTUAL FUND SCHEMES

In the investment market, one can find a variety of investors with different needs, objectives and risk taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risk than a person who is just on the verge of his retirement. So, it is very difficult to offer one fund to satisfy all the requirements of different investors. Just as one shoe is not suitable for all feet, one fund is not suitable to meet the vast requirement of all investors. Therefore, many types of funds are available to the investors. It is completely left to the discretion of the investor to choose anyone of them depending upon his requirement and his risk taking capacity. The mutual fund schemes can be broadly divided into three categories on the basis of their structure, investment objectives and various other schemes.

BY STRUCTURE: CLOSE-ENDED FUNDS AND OPEN-ENDED FUNDS

Close-ended Funds: Under this scheme the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of the investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding.

Open-ended Funds : It is just the opposite of close ended funds. Under this scheme the size of the fund and/or the period of the fund is not pre determined. The investors are free to buy and sell any number of units at any point to time. For instance, the unit scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can purchase this unit at anytime and sell it also at any time at his discretion.

BY INVESTMENT OBJECTIVE: GROWTH FUNDS, INCOME FUNDS, BALANCED FUNDS AND MONEY MARKET FUNDS

Growth Funds: Unlike the income funds, Growth Funds concentrate mainly on long run gains i.e. capital appreciation. They do not offer income and they aim at capital appreciation in the long run. Hence, they have been described as "Nest Eggs" investments.

Income Funds: As the very name suggests, this fund aims at generating and distributing regular income to the members on a periodical basis. It concentrates more on the distribution of regular income and it also sees that the average return is higher than that of the income from bank deposits.

Balanced Funds: This is otherwise called "income-cum-growth" fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

Money Market Funds: The aim of Money Market Funds is to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer short-term instruments such as Treasury Bills, Certificates of Deposit, Commercial Paper and Inter-Bank Call Money. Returns on these schemes may fluctuate depending upon the interest rates prevailing in the market. These are ideal for corporate and individual investors as a means to park their surplus funds for short periods.

OTHER SCHEMES: TAX SAVING SCHEME, INDEX FUNDS, SECTORAL SCHEMES, LEVERAGED FUNDS, DUAL FUNDS AND BOND FUNDS

Tax Saving Scheme: These schemes offer tax rebates to the investors under specific provisions of the Income Tax laws as the Government offers tax incentives for investment in specified avenues. Investments made in Equity Linked Savings Schemes (ELSS) and Pension Schemes are allowed as deduction under Section 88 of the Indian Income Act, 1961.

Index Funds: Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice versa.

Sectoral Schemes: Sectoral Funds are those which invest exclusively in specified sector(s) such as FMCG, Info Tech, Pharmaceuticals, etc. These schemes carry higher risk as compared to general equity schemes as the portfolio is less diversified, i.e. restricted to a sector/industry.

Leveraged Funds: These funds are also called borrowed funds since they are used primarily to increase the size of the value of the portfolio of a mutual fund. When the value increases, earning capacity of the fund also increases.

Dual Funds: This is a special kind of close ended fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks i.e. income shares and capital shares.

Bond Funds: These funds have portfolios consisting mainly of fixed income securities like bonds. The main thrust of these funds is mostly on income rather than capital gains.

IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. In the absence of mutual funds, these savings would have remained idle. Thus, the whole economy benefits due to the cost efficient and optimum use and allocation of scarce financial and real resources in the economy for its development. Investors can enjoy the wide portfolio of the investment held by the mutual fund. The fund diversifies its risks by investing on a large variety of shares and bonds, which cannot be done by small and medium investors. This is in accordance with the maxim 'not to lay all eggs in one basket'. Thus mutual funds provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings. The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus they are able to command better market rates and lower rates of brokerage. So they provide better yields to their customers. The management of fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgment and experience.

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each fund maintains a large research team which constantly analyzes the companies and the industries and recommends the fund to buy or sell a particular share. Thus investments are made purely on the basis of a thorough research. Certain funds offer tax benefits to its customers. Thus apart from dividends, interest and capital appreciation, investors also stand to get the benefit of tax concession Mutual funds themselves are totally exempt from tax on all income on their investments. Some mutual funds have permitted the investors to exchange their units from one scheme to another scheme and this flexibility is a greater boon to investors. Income units can be exchanged for growth units depending upon the performance of the funds. One cannot derive such a flexibility in any other investments. Even a very small investor can afford to invest in mutual funds. They provide an attractive and cost effective alternative to direct purchase of share. In the absence of mutual funds, small investors cannot think of participating in a number of investments with such a meagre sum. There is greater liquidity. Units can be sold to the fund at any time at the net asset value and thus quick access to liquid cash is assured.

An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is very tedious and consumes a lot of time. Thus record keeping is the biggest problem for investors. The investor has to keep a record of only one deal with the mutual fund. The mutual funds sends statements very often to the investor. Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures. The mutual fund not only create a demand for these capital market instruments but also supply a large source of funds to the market, and thus, the industries are assured of their capital requirements. In most cases investors are not able to get allotment in IPOs of companies because they are often oversubscribed. Moreover, they have to apply for a minimum, of 500 shares, which is very difficult particularly for small investors. But, in mutual funds allotment is more or less guaranteed. Mutual funds are also guaranteed a certain percentage of IPOs by companies. Mutual funds help to reduce the marketing cost of new issues. The promoters used to allot a major share of the Initial Public Offering to the mutual funds and thus they are saved from the marketing cost of such Issues. An individual investor cannot have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand mutual funds keep the money market active by investing money on the money market instruments.

SELECTION OF A FUND

Mutual funds are not magic institutions which can bring treasure to the millions of their investors within a short span of time. All funds are equal to start with. But in due course of time, some excel over the others, it all depends upon efficiency with which the fund is being managed by the professionals of fund. Hence, the investor has to be very careful in selecting a fund. One must see the objective of the fund-whether income oriented or growth oriented. Income oriented are fixed interest yielding securities like debentures and bonds whereas growth oriented are backed by equities. A mutual fund is always intended to give steady long-term returns, and hence, the investor should measure the performance of a fund over a period of at least three years. Investors are satisfied with a fund that shows a steady and consistent performance than a fund which performs superbly in one year and then fails in the next year. The success of any fund depends upon the competence of the management, its integrity, periodicity and experience. The fund’s integrity should be above suspicion. A good historical record could be a better horse to bet on than new funds. The prospective investor should scrutinize the expense ratio of the fund and compare it with others. Higher the ratio, lower will be the actual returns to the investor. The efficiency of a fund manager can be tested by means of the innovative schemes he has introduced in the market so as to meet the diverse needs of investors. An innovator will always be a successful man. The most important factor to be considered is prompt and efficient servicing. Services like quick response to investor queries, prompt dispatch of unit certificates, quick transfer of units, immediate encashment of units etc. will go a long way in creating a lasting impression in the minds of the investors. It has been found that the stock market index and inflation rate tend to move in the same direction whereas the interest rates and the stock market index tend to move in the opposite direction. This sets the time for the investor to enter into the fund and come out of it. The success of a mutual fund depends to a large extent on the transparency of the fund management. In these days of investor awareness, it is vital that the fund should disclose the complete details regarding the operation of the funds. It will go a long way in creating a lasting impression.

CONCLUSION

During the past 20 years, mutual funds have dramatically changed the face of investing by making financial markets accessible to everyone. Millions of people have found that mutual funds are an ideal way to invest because they offer instant diversification and professional investment management, among other things. Before investing in mutual funds, it is important to understand how they work. A mutual fund pools money from many different people who choose to invest because they share the same investment objective. Each investor receives a proportionate share of the funds' investment returns, which may include dividends, interest, and capital gains or losses. Mutual funds offer many advantages including buying power, tax advantages, and convenience. They are also highly regulated investment vehicles, with governing bodies like the Securities and Exchange Commission (SEC) in place to protect investors. Stocks represent shares of ownership, in a public company. Examples of public companies include IBM, Microsoft, Ford, Coca-Cola, and General Mills. Stocks are the most common ownership investment traded on the market. Just like shares, the price of units of a fund is also quoted in the market. This price is governed basically by the value of the underlying investment held by that fund. At this juncture, one should not confuse a mutual fund investment on units with that of an investment on equity shares. Investment on equity shares represents investment in a particular company alone. On the other hand, investment on a unit of a fund represents investment in the parts of shares of large number of companies. This itself gives an idea how safe the units are. If a particular company fails, the shareholders of that company are affected very much whereas the unit holders of that company are able to withstand that risk by means of their profitable holdings in other companies shares. Again, investment on equity shares can be used as a tool by speculators and inveterate stock market enthusiasts with a view to gaining abnormal profits. These people play an investment game in the stock market on the basis of daily movement of prices. But, mutual funds cannot be invested for such purposes and the mutual fund is not at all concerned with the daily ebbs and flows of market. In short, mutual fund is not the right investment vehicle for the speculators. Mutual funds are, therefore, suitable only to genuine investors whereas shares are suitable to both the genuine investors and the speculators.

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