Mutual Fund Industry and its Prospects in Indian Scenario

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Abstract

Institutions and banks have been an integral part of capital market operations. Small investors, who possess limited income, find it difficult to pool their saving in the capital market. To cater the needs of small investors under the guidance of professional team of experts mutual fund came into existence. Moreover, India's savings rate has been between 30-35 percent since last few years but investment in mutual funds have been minimal as compared to other avenues of investment. However, mutual fund business follows a Business to Business model (B2B) rather than a Business to Consumer (B2C) model and hence, distribution is a critical success factor for any mutual fund. Thus, an effort is being made by the professionals to make mutual fund as a pull model rather than a push model. The paper aims to center towards the inception and growth of mutual fund in India. Indian mutual fund industry has witnessed considerable growth since its inception in 1963. Assets Under Management (AUM) have surged to Rs 8,684 bn in June 13 from just Rs 250 mn in Mar 65. In a span of 48 years, the industry has registered a CAGR of 24%. The impressive growth in Indian Mutual fund industry in recent years can largely be attributed to various factors such as rising household savings, comprehensive regulatory framework, favorable tax policies, and introduction of several new products, investor education campaign and role of distributors. Thus, in this paper an effort is being made to capture the key prospects of mutual fund along with challenges faced by under penetrated Indian market.

Key Words: Mutual fund, AUM, CAGR, UTI

I. Introduction

Capital markets drive the resources of country to industries and mobilize them to productive use. Banks, FIIs, private firms participate in the allocation and mobilization process as they possess requisite team of professional experts to judge the productive avenues for investment. However, ordinary small investors face myriad of problems in the capital market. They lack in information, professional advice and have limited resources at disposal. Mutual funds have emerged as a boon to provide much needed help to these investors.

The origin of mutual funds could be rooted back when the government of India, in order to fulfill the twin objectives of mobilizing household savings and investing these savings in the capital market for industrial growth, set up Unit Trust of India,1964. Household sector constituted for about 80% of country's savings and 1/3rd was available to the corporate sector.

II. Objective

This paper aims at unfolding the different facets of emergence and growth of mutual funds in India. At the same time, it identifies the shortcomings and improvement areas for the development of mutual funds.

III. Research Methodology

The paper is an exploratory one that evaluates operations of mutual funds and suggests some measures to make it a successful scheme in India.

IV. Emergence of Mutual Fund Industry in India

Unit Trust of India launched its first open-ended equity scheme called Unit 64 in the year 1964, which turned out to be one of the most popular mutual fund schemes in country. In

1987, the government permitted other public sector banks and insurance companies to promote mutual fund schemes. Pursuant to this relaxation, six public sector banks and two insurance companies' viz. Life Insurance Corporation of India and General Insurance Corporation of India launched mutual fund schemes in the country. Subsequently, in 1993, Securities and Exchange Board of India ("SEBI") introduced The Securities and Exchange Board of India (Mutual Funds) Regulations, 1993, which paved way for the entry of private sector players in mutual fund industry.

In the period between 1963 to 1988, when UTI was the sole player in industry assets under management grew to about Rs. 67 billion. In the second phase between 1988-1994, when public sector banks and insurance companies were allowed to launch mutual fund schemes, the total assets in mutual fund industry grew to about Rs. 610 billion with the total number of schemes increasing to 167 by the end of 1994. Third phase of mutual fund industry, which commenced in 1994, witnessed exponential growth of industry, with the advent of private players therein. Kothari Pioneer Mutual fund was the first fund to be established by the private sector in association with a foreign fund. As on September 30, 2002, the total assets under management stood at Rs. 1069 billion and the total number of schemes stood at 384.

Indian mutual fund industry had seen a dramatic improvement, both qualities-wise as well as quantity-wise. Before, the monopoly of market had seen an ending phase; Assets Under Management (AUM) was Rs.67 bn. Mutual fund industry can be broadly put into four phases according to development of the sector. Each phase is briefly described as under:

A. First Phase - 1964-87

Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978, UTI was de-linked from RBI, and Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. First scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

B. Second Phase - 1987-1993 (Entry of Public Sector Funds)

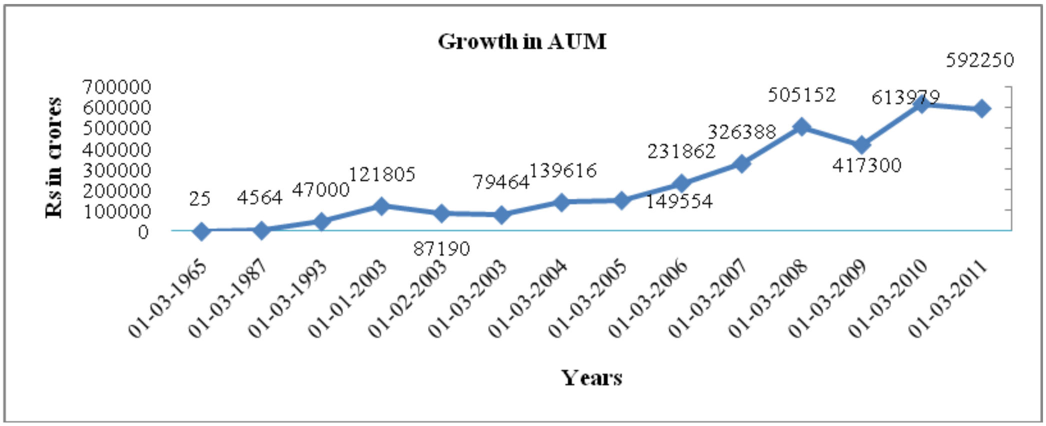
During this period, banks entered into mutual fund market. Pioneered by SBI Mutual Fund (June 87) followed by Canbank Mutual Fund (Dec 87), PNB Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC in 1989 and GIC in 1990. By the end of 1993 AUM was Rs.47,004 crores.

C. Third Phase - 1993-2003 (Entry of Private Sector Funds)

Third phase saw the entry of private sector funds. There was change in regulation of mutual fund. It was now governed by SEBI (MF) Regulation Act, which was further revised in 1996. Erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. Total AUM was 1.21 lakh crores invested by the end of Jan. 2003. SEBI (Mutual Fund) Regulations, 1993 were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. Number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. Unit Trust of India with Rs. 44,541 crores of assets under management was way ahead of other mutual funds.

D. Fourth Phase - since February 2003

In February 2003, following the repeal of Unit Trust of India Act, 1963, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with assets under management of Rs. 29,835 crores as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of Mutual Fund Regulations. Second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs. 76 thousand crores of assets under management and with the setting up of a UTI Mutual Fund, conforming to SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. Graph 1.1indicates the growth of assets over the years.



Graph 1.1: Growth Trend of CAGR

Source: www.amfiindia.com

Erstwhile UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. Assets under management of the

Specified Undertaking of Unit Trust of India have therefore been excluded from total assets of the industry as a whole from February 2003 onwards.

Industry recorded an AUM of INR 8,800 billion. The highest AUM was recorded in August 2013 as INR 9,580 billion. Though on the whole, mutual fund industry witnessed a decline in AUM in December 2013, AUM of equity funds increased by 4.5 per cent on account of rising stock prices.

One could see a shift with the changing demographic profile of the Indian investors, with new products being launched (for example, products being linked to pensions), coupled with financial awareness and literacy initiatives for investors both by the industry and the regulators, and with the onus of expanding the market falling on distributors—the first point of contact for investors. Distributors would have to convince and guide the investors about using mutual funds as a tool for financial goals rather than as just mere investment. Technology could definitely act as an enabler in reaching out to investors in far and distant places.

V. The Potential of Mutual Funds

1. With the emphasis on increase in domestic savings and improvement in deployment of investment through markets, the need and scope for mutual fund operation has increased tremendously. The basic purpose of reforms in financial sector was to enhance the generation of domestic resources by reducing dependence on outside funds. This calls for a market based institution which can tap the vast potential of domestic savings and channelize them for profitable investments. Mutual funds are not only best suited for the purpose but also capable of meeting this challenge.
2. An ordinary investor who applies for share in a public issue of any company is not assured of any firm allotment. But mutual funds who subscribe to the capital issue

made by companies get firm allotment of shares. Mutual fund later sells these shares in the same market and to the promoters of company at a much higher price. Hence, mutual fund creates the investor's confidence.

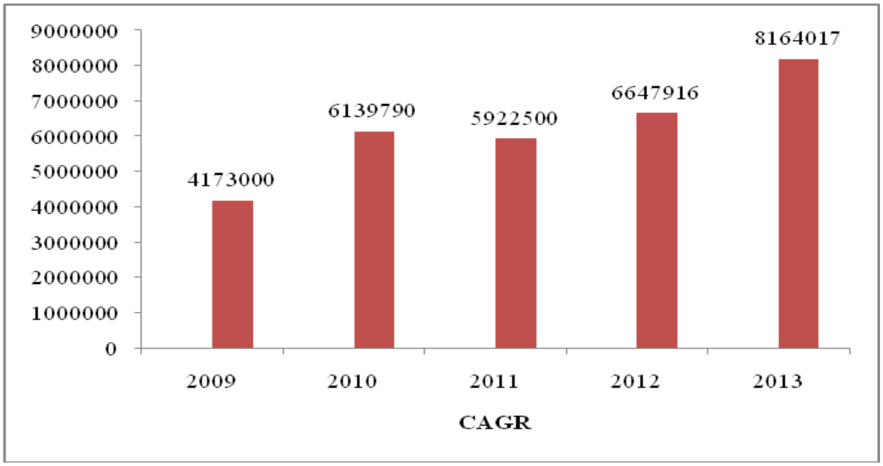
3. Psyche of the typical Indian investor has been summed up by Mr. S.A. Dave, Chairman of UTI, in three words; Yield, Liquidity and Security. The mutual funds which is being set up in public sector, have given the impression of being as safe avenue for investment as bank deposits.
4. As mutual funds are managed by professionals, they are considered to have a better knowledge of market behaviours. Besides, they bring a certain competence to their job. They also maximise gains by proper selection and timing of investment.
5. Another important thing is that the dividends and capital gains are re-invested automatically in mutual funds and hence are not frittered away. The automatic reinvestment feature of a mutual fund is a form of forced saving and can make a big difference in the long term.
6. Mutual fund operation provides a reasonable protection to investors. Besides, presently all schemes of mutual funds provide tax relief under Section 80 L of the Income Tax Act and in addition, some schemes provide tax relief under Section 88 of Income Tax Act which led to the growth of importance of mutual fund in minds of the investors.
7. As mutual fund creates awareness among urban and rural middle class people about the benefits of investment in capital market, through profitable and safe avenues, mutual fund could be able to mobilize a huge amount of the surplus funds from them.
8. Mutual fund attracts foreign capital flow in the country and secures profitable investment avenues abroad for domestic savings through the opening of off shore funds in various foreign investors. Lastly, another notable thing is that, mutual funds are controlled and regulated by SEBI and hence are considered safe. Due to all these benefits the importance of mutual fund has been increasing.

VI. Growth Evidences

MF industry in India has undergone a most successful phase in the recent times, crores of rupees was pumped by the retail investors, which were handsomely awarded in the form of double or even triple digit dividends. The success story lies due to rocking performance of Indian market. Asset management companies (AMCs) realise that they need to restructure their businesses in order to meet the evolving needs of their clients and provide them with complete investment solutions. Although emerging markets such as India provide a wide range of opportunities, it is important to tap into these avenues to fuel the growth of mutual fund industry. Indian mutual funds industry has shown commendable growth .Yet, it has a long way ahead to come at par with developed economies. In comparison to global markets, India's AUM penetration as a per cent of GDP is between 5-6 per cent while it is around 77 percent for the U.S., 40 percent for Brazil and 31 percent for South Africa.

There are 44 AMCs operating in the sector, approximately 80% of the AUM is concentrated with 8 of leading players in the market. There have been recent instances of consolidation in the market and market concentration is expected to remain in the near-term.

Amidst volatility and uncertainty in the markets, average assets under management (AUM) posted a growth of 23% for the year ended March 2013. This was considerably higher than the 12% growth reported in March 2012. Industry has grown at a Compound Annual Growth Rate (CAGR) of 18% from 2009 -2013. However, the trend from 2010 depicts that net sales for mutual fund industry has dipped, picking up slightly in 2013, to grow by 7%.



Graph 1.2: Growth Trend of CAGR

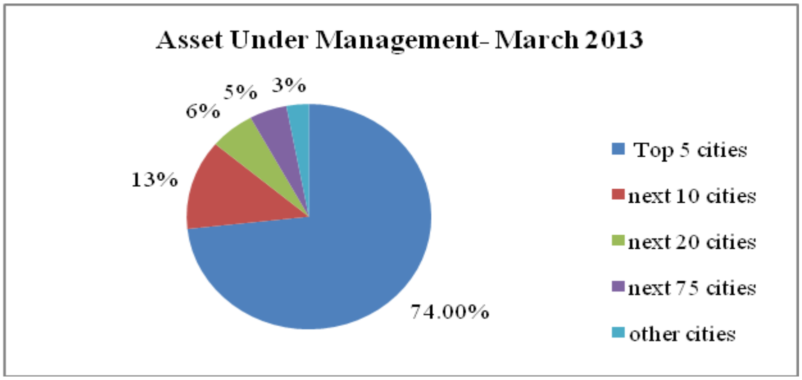
However, a total of 139 new schemes were launched for the year ended March 2013, generating sales of 236,470 million INR. Furthermore, AUM under the equity segment has actually declined 5%, whereas the debt segment has grown significantly at 36%, which implies that investors are still wary of investing in the market looking for relatively safer investments by directing their investments into the debt bucket. Assets under management in the liquid and money market and gold Exchange Traded Funds (ETFs) increased by 16% and 18% respectively.

Even though the industry has witnessed growth during last year, the rise in AUM has been coupled with erosion of the investor base, evident from the loss of 3.6 million folios as in March 2013. Equity segment saw a decline of 4.4 million folios, although the debt segment showed an addition of 0.8 million folios. This indicates that investors are inclined towards relatively safer investments, not wanting to take risk in these volatile and uncertain markets.

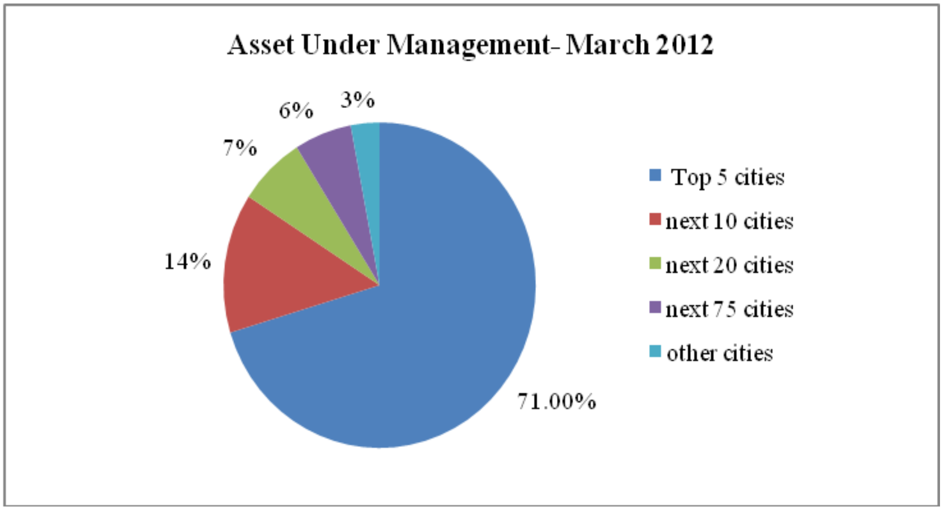
VII. Under-Penetrated Market in India

Extent of under-penetration in the market is a sore point with banking and financial services industry, with a large amount of savings being channelized into gold and real estate rather than the capital market. GDP growth has slowed down, sluggish at 5% in 2012-13, with savings and investment rates following a downward trend. In 2010-11, the savings and investment rates were 34% and 36.8%, respectively, which declined to 30.8% and 35%, respectively, in 2011-12 and 31.8% and 35.4% in 2012-13.

For savings to be streamlined into the capital market, investors need to first and foremost be made aware of avenues and opportunities. However, AUM growth largely remains restricted to top 5 cities in India viz. Mumbai, Delhi, Bangalore, Chennai and Kolkata. Top 35 cities continue to contribute around 90-92 percent of the industry AUM. Mutual fund industry is yet to spread its reach beyond Tier I cities. Top five cities contribute to 74% of the pie, with remaining 26% distributed among other cities (Figure 5). Statistics show that in March 2013, penetration in top five cities increased to 74% as compared to 71% in March 2012, whereas for cities beyond the top five, penetration has decreased. One of the prime areas the industry is focusing on, is developing the penetration ratio and increasing its presence in other cities.



Graph 1.3: Asset under Management- March 2013



Graph 1.4: Asset under Management- March 2012

Rationale for Under-Penetrated Market:

- Lack of Financial Education and Awareness

  Financial literacy is one of the most fundamental factors impeding the growth of penetration of any financial products in the smaller cities and towns. Investors need to be made aware of their financial goals and means to achieve the same. AMFI and SEBI along with the industry are making efforts for investor awareness campaign. Fund houses are also mandated by regulation to invest 2 bps from scheme expenses towards, investor education and awareness campaigns but India has a long way to go.

- Limited Distribution Network

  Second critical issue for fund houses to distribute their products in smaller cities is the availability of quality distribution infrastructure. Fund houses need infrastructure like branches, adequate number of relationship managers and sales service staff in these locations to be able to increase their sales volume coming from these geographies.

- Distribution Cost

  Cost of establishing a distribution network in B-15 cities is quite high. It is the cost per transaction or the low sales volume that makes pursuit economically unviable or at the least challenging. Although, additional TER (Total Expense Ratio) can be levied to extend of inflows from these cities (up to 30 bps); entering these markets have a long gestation period and requires a capital investment for distributors.

- Cultural bias towards Physical Assets

  As of FY13, 46 percent of total individual wealth in India is invested in physical assets (gold and real estate). Although, in past few decades, the investors have increasingly relied on financial assets to invest their savings; contribution of MFs in asset portfolio is very low. Insurance products constitute 17 percent of individual savings in financial assets, whereas the share of mutual funds is much lower at 3.2 percent.

VIII. Conclusion

Mutual funds industry aims to break the barrier between small investors and capital market. Although progress is made by the entry of UTI, entry of public and private sector funds, regulatory reforms, assets under management has increased consistently. For past 5 years, it grew at a CAGR of 18%. There has been a shift in investor clientele towards debt segment. Mutual fund still remains concentrated to top 5 cities contributing 74% of AUM. Rest of the cities are still untapped. This is because of the slow capital market growth, lack of awareness of mutual funds being a low-cost investment vehicle and the returns they can generate. In this case, there is also the interplay of cultural and behavioral change which prevents savings from being streamlined into investment products, diverted from gold or property. Indians still feel that gold and property is a less risky alternative as compared to investment in the capital markets. Also, investors are not aware of low risk products that they can invest in. A culture change is required in this case, if people are to be convinced to invest in capital markets.

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