# Mutual Funds : Key lessons learnt from the last decade

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The last decade has been quite eventful for the mutual fund industry as well as all those associated with it i.e. investors, distributors, registrar and transfer agents etc. Despite a rousing comeback in 1999, most part of the year 2000 was a difficult one for the industry and, so far, 2001 continues to be a challenge. Until 1999, the last good year for the mutual fund industry was 1994. A combination of a booming stock market and emergence of private sector players resulted in that year being a fantastic one for the industry. Before this, during the year 1992, Unit Trust of India (UTI) managed to achieve quite an amazing feat of moblising money from more six million investors in its Mastergains- 92 scheme. The year 1993 was an important one in more than one ways. During that year, Mutual Fund Regulations came into being and the first private sector mutual fund also started its operations in the same year.

As is evident, the mutual fund industry has had a roller-coaster ride in the last decade. It witnessed some very good and some very bad years. In other words, the growth of the industry has been quite erratic. At the same time, there is no doubt about the fact that the industry is emerging as one of the most effective saving vehicles for investors with varied needs and profiles.

The last decade has taught a lot to both the industry as well as all those associated with it. Let us look at how the industry has evolved during the last decade and the lessons learnt by all concerned during this period.

In the beginning of the last decade, only public sector mutual funds were in existence. While UTI dominated the market, others were in the process of establishing themselves. However, most of them looked up to UTI to set the trend both in terms of product as well as client servicing. As regards the product range, with a few exceptions from UTI, all others were closed ended ones. There was a clear preference for assured return products.

However, with the emergence of private sector players, the scenario changed completely. Even though there were apprehensions regarding the kind of response private sector players would get from the investing public; as most experts were of the opinion that investors had got used to the safety of investing with public sector, the schemes launched by the private sector players evoked excellent response. Obviously, investors were expecting improved performance, better service, transparency and innovations from them.

The new players came in after doing lot of homework as regards their positioning. Realising that they were not allowed to launch assured return products and the fact that they did not have any track record, they focused on making professional fund management and client servicing their edge. In fact, they redefined the concept of client servicing in India. In addition, they brought about much needed transparency to the Indian mutual fund industry. As a result, the initial offerings of almost all the private sector mutual funds were huge successes. Clearly, the expectations were very high and that became a problem for them.

With the downturn in the stock market resulting in falling NAVs, questions were raised about the manner in which these funds sold their schemes. Since most of the players in the private sector did not have resources and the time at their disposal to build their own distribution channels, they relied mainly on IPO brokers to do the job for them. In other words, they relied on these IPO brokers to counter the "reach advantage" that the public sector mutuals had at that point of time. Obviously, these brokers sold mutual funds units as any other IPO. Besides, to an extent, even the players themselves were guilty of wrong positioning.

Those were the days of closed ended funds. The booming stock market as well as the eye-popping results of growth schemes fuelled the expectations of all and sundry. Completely risk averse investors were happily investing in these schemes and the absence of quality distributors as well as lack of efforts on the part of the industry to educate investors made things even worse. As a result, investors came in with unrealistic expectations.

The reality dawned in 1995, when the stock market entered into a long bearish phase. Obviously, this experience made investors averse to mutual funds. The industry stung by this sudden reverse did try to explain that mutual funds were long-term investment vehicles and that the short-term performance should not viewed as non-performance, but it was too late. This was the beginning of a long struggle for mutual funds as investors started deserting the industry. That's when, the mutual funds, at least in the private sector, learnt their first lesson.

Realising the fear investors had about liquidity, discounts in the secondary market and their inability to deal in the secondary market etc., the industry began to look at open-ended schemes to bring investors back to its fold. Open-ended schemes were projected as an answer to the ills of closed ended schemes. Open-ended schemes evoked a mixed response from the investing public. In the beginning, these schemes were positioned as the most liquid of instruments and were sold as an alternative to savings bank account. In other words, emphasis was on liquidity and it appeared as if performance took a back seat. These products too suffered like closed ended schemes, since prices were lower than the face value when the schemes went open for sales and redemptions. Investors started wondering whether these were just closed ended schemes in different clothing. The reason it happened is easy to understand; mutual funds were required to re-open the sale of units on an going basis on the 91st day after the closure of the Initial Offer and hence the same factors that depressed the initial NAVs of the closed ended schemes also affected open-ended schemes.

Mutual funds were quick to realize this and started launching no-load and in some cases low load funds to ensure an initial NAV that was at least equal to face value, if not more. In the meantime, a sagging stock market kept investors away from equity funds and mutual funds turned their attention to income schemes to offer variety as well as a product that was not affected by the vagaries of the stock market. In addition, they started looking for new avenues for distribution to make a beginning in ensuring that the funds were marketed by the right people and to the right people. Moreover, mutual funds made investing as well as redemptions a very straight and speedy process. The paper work required was minimal and simple.

SEBI on its part realised the gravity of the situation and, after consulting the industry, revised the regulations in December, 1996. It was indeed a step in the right direction. The new regulations provided fund managers with the much needed freedom and flexibility in investments and product design. Besides, the new regulations reaffirmed the fiduciary role of the trustees by increasing their direct responsibility to protect the interest of the investors. In addition, the introduction of disclosure norms added to transparency and control of mutual funds thus enhancing investor protection. Not that the new regulations were expected to change the face of the industry overnight, but the fact that regulators acknowledged the difficulties faced by the industry helped in changing the perception.

In the meantime, the industry continued its process of restructuring and overhauling the portfolios of equity funds. Over the next couple of years, the fruits of this effort became visible as funds performance started showing improvement. Following the growth of mutual funds in'98, investors' interest in mutual funds continued in 1999. Finally, with the 1999 budget giving special tax sops for mutual funds, the industry got just the kind of impetus required to turn the positive developments into a meaningful trend. The tax benefits made dividend distribution tax-free in the hands of the investors. Even though, the government did impose a 10 percent withholding tax on debt-oriented funds, they were still tax-efficient for individual investors in higher tax brackets as well wholesale investors. No wonder, these schemes became very popular among even banks and financial institutions.

The industry witnessed renewed interest in the equity funds thanks to the booming stock market and the tax sops. During this period, some of the equity funds gave three digit annual returns, which made most of the investors believe that it was a great opportunity for them to make money in the short-term. Surely, in times like these, it is very difficult to resist the temptations to make a quick buck. Even a section of hard-core debt fund investors abandoned its favourite vehicle and joined the bandwagon.

A plethora of sector funds, mainly IT funds, fuelled their expectations. While sector specific funds can be lucrative for those willing to accept a higher level of volatility in the short-term, most investors in these schemes were not ready for this. Once again, they abandoned the equity funds forcing the industry to wonder as to whether they could have done something to avoid this situation. While it may not be fair to blame the industry alone for yet another setback, perhaps it should have segmented the market and trained the distributors before launching so many sector specific funds.

The distributors realizing that selling mutual funds products is a different ball game started offering services like investment planning as well as investment advice. In other words, some of them have made a conscious effort to move away from incentive driven selling. For the sake of all concerned with this industry, let us hope that the part timers as well as discount brokers would fade away. It is important that distributors realize that their role in the whole process is much more than just sharing the brokerage. The key is to build up relationship rather than making one-off transaction.

On the other hand, it is high time investors realise that they themselves have an important role to play in the investment process. They will also have to learn from their past mistakes and re-look at mutual funds in the right prospective. They will do well to remember that the best way to invest in a mutual fund scheme is by understanding one's needs, time horizon as well as the risk profile and, avoid the tendency of investing all their money in one asset class. The key is to do a proper asset allocation with the help of an advisor. Mutual funds are the most ideal vehicle to practice asset allocation. Even in a market like today, some investments do better than others. That's why one should examine one's asset allocation at least once a year and make adjustments

Moreover, saving and investing are often used interchangeably, but they are different. Saving is storing money safely, whereas investing is taking a risk with a proportion of your savings in hope of realising higher long-term return. Long term investing is the best hedge against inflation, but one needs to save in order to invest.

Another lesson for investors from the experiences of the last decade is to avoid market timing. There were many investors who believed that the best way to avoid losses and maximize gains is to use "market timing"- a strategy in which one tries to buy before the market goes up and sell before it declines. Unfortunately, very few can predict with any degree of accuracy when, and how much, the prices will rise and fall. It is important to remember that even experts cannot forecast market movements consistently. By avoiding the strategy to time the market, one can avoid jumping into the market after the sustained rally or sell at a loss when the prices fall. It must be remembered that invariably the rallies tend to occur in spurts. Therefore, there is a high risk of missing those rallies. There is an interesting example to corroborate this. According to a study conducted by the University of Michigan, 95% of the market gains between 1963 and 1993 stemmed from the best 1.2% of the trading days. The message is clear: one needs to maintain a disciplined approach towards investing.

Remember, there will always be bull and bear markets, interest rates will rise and fall and it will always be nearly impossible to predict the economic scenario right round the corner. The best one can do is to take an informed and sensible approach; invest for the long-term. One should always remember the rule of 72. It states that the numbe of years required to double money is equal to 72 divided by the rate of return one earns. For example, an investment earning a real rate of return of 12% annually will double in six years in real term.

Similarly, a long-term approach by mutual funds will ensure survival and prosperity. Due to erratic growth of the industry in India, a significant majority of investors has remained unaware of or is not fully aware about the concept of mutual funds and their utility as an investment vehicle. Besides, lack of a focused effort on the part of the industry as well as distributors to expand the market has not helped the cause of the industry. As a result, the mobilizations from the wholesale segment dwarf collections from the retail segment. But there is no doubt about the fact that retail investors will become active in the near future. Investors who have got used to assured returns will re-examine their strategies and seek more flexible and potentially higher yielding investment products like mutual funds than the previously favoured instruments offering administered rate of returns. The recent cut in the small saving rate will hasten the process.

No doubt, the industry will have to ensure a consistent performance to be able to win the confidence of investing public, In fact, apart from the performance, the industry needs to work hard on increasing its reach, making investing more simple as well improve the quality of advice to the prospects. It is here that entities like banks, registrars and transfer agents and distributors, who have been an integral part of the mutual fund industry, will have to play an important role in making this mission successful. There is a lot of scope for theses entities and the mutual fund industry to work and grow together. Of course, investors will have everything to gain from this.

The mutual fund industry in India can take a cue from its counterpart in the US to motivate itself. In the US, one in three Americans was invested in mutual funds in 1999 as against one in 18 in 1980. No doubt the mutual fund industry has a lot to gain by remaining focussed on its efforts to get the glory it deserves.

(The views expressed here are personal)