Prospects for Mutual Fund Industry

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The mutual fund industry is a uniquely important part of the Indian financial sector and has a considerably large potential for growth. The industry, however, needs to be in strategic preparedness to take advantage of the emerging opportunities. The fund management industry would have to become highly innovative in product design and distribution, as well as cost competitive to enable it to exploit the growth opportunities provided by infrastructure financing, and liberalisation of pension funds sector. This article briefly reviews the recent trends and outlines the emerging opportunities for the industry.

Mutual Fund Industry

Mutual Funds, over the years, have helped channelise large amounts of savings into investments in industry and other productive economic activities. Mutual funds today have a significant presence in the capital market with market value of assets of over Rs.80,000 crore, or about US$ 20 billion. UTI and the 33 Asset Management Companies have already established a large client base reflected in the 60 million unit-holding accounts. Of the total funds, nearly 35 percent is in debt funds, 36 percent in balanced funds and 29 percent in equity funds. At present there are around 230 schemes in operation. Of these, 60 are open-end and 170 are closed-end schemes.

The mutual fund industry saw phenomenal growth during 92 to 94, when the industry mobilised about Rs. 57,000 crore and UTI alone mobilised Rs.49,000 crore during this period. This period of spectacular growth was, however, short-lived and the industry entered into a relatively sluggish phase from 1995 onwards. During 95 and 96, the mutual fund investors, for the first time, realised that their high return expectations may not always be met. They also found to their surprise that mutual fund units can trade at discounts to NAV because of imperfections in the market. During this period(95 to 96), investors also experienced erosion in the value of their investments in equity-oriented schemes.

In this context, it is essential to understand the investors perception of the performance of mutual funds. From December 94 upto 97, the secondary equity market was, for most of the time, passing through a bearish phase. On a point-to-point basis, seldom has the market index been at a higher level than the level it had reached in September 94. This made it difficult for fund managers to generate returns that the investors were looking for. No doubt professional fund management has helped investors restrict erosion in the values of their investment compared with the market but it is poor consolation for the investors, who are expecting higher returns.

Thus, despite the better-than-average performance of mutual funds, the perception remained one of poor performance. That had something to do with the expectations of the investors in terms of returns. For the common investor, the benchmark was not the stock market return, but the return on bank fixed deposits. The lower-than-expected returns led investors to gradually shift away from mutual fund industry. Thus, from very high growth during 91-94, the industry went into a slump in 95 and 96 and average annual sales declined to Rs.9,000 crore per year in 95-96 as compared to Rs.14,000 crore during 91-94. In fact, during this period, the repurchases and redemptions exceeded the fresh sales and the mutual funds started facing the problem of net outflow of funds in a sluggish capital market.

Looking to the potential, the period of sluggish growth is coming to an end and the future for fund management industry is indeed bright. With faster economic growth, following liberalisation, the volume of savings is expected to increase substantially. During the Ninth Five Year Plan, the savings rate is expected to increase from the prevailing levels of 21 percent to 24 percent to over 26 percent. Significantly, the household sector which contributes about 80 percent of the Gross Domestic Savings, has over 50 percent of the savings in financial assets. By the year 2001, gross financial savings are expected to exceed Rs. 3,20,000 crore at current prices. If the mutual funds target a share of 7 to 10 percent of household sector's financial assets, they should be mobilising annually Rs.21,000 crore to Rs.32,000 crores. And this target is easily achievable, because even in 93-94, the share of mutual funds in gross financial savings was as high as 7 percent.

For exploiting this growth potential, it is necessary to project the performance of the funds properly to the investors. The advantages of the newer types of funds have to be explained to the common investors particularly from the risk-return perspective. This is where a realistic assessment of fund managers is extremely critical. Investors, regulators and fund managers are equally interested in knowing about the performance of funds. Many analytical and statistical techniques are used to evaluate performance of funds.

Close-end funds that are listed on the exchange are trading at a discount to the prevailing NAV. This also influences the decision of investor to invest in mutual funds. Overall market sentiment plays a very significant role in the premium or discount to NAV. When investors are particularly bullish, the mutual funds are even traded at premium to the NAV. Again, when investors are bearish, funds tend to trade at discount. Discounts are expected to come down further once the equity markets enter a bullish phase.

Investors also need to be educated on the common fallacy of comparing returns of debt-oriented fixed-income mutual funds with fixed income securities of companies without considering associated risks. Marketing communication needs to project that investment in a mutual funds helps reduce the portfolio risk or provide higher return at the same level of risk, over the longer term. At the same time, inappropriate selling of mutual fund products has to be avoided. As the past experience suggests, investors' expectations should not be raised in a manner that is not consistent with the nature of the product. This will help alleviate the pressure of undue expectations of investors from the fund managers. In the past, fund managers have not been able to live upto the expectations that have been raised by the distributors. As a result, the investors have lost faith in the fund management industry.

With increasing investor awareness, greater disclosure of information on fund management would be essential and disclosures should not to be viewed merely as regulatory requirements for investor protection.

New opportunities are likely to be available soon for mutual funds to improve their fund management performance. Derivatives, as and when they are introduced, will help mutual funds design new products for investors, and give a lot of flexibility to the fund manager. With the help of derivatives, the fund manager will be able to improve returns and reduce down side risk by hedging his portfolio. The report by Dr.L.C. Gupta Committee on introduction of derivatives, is currently being discussed. SEBI has accepted the contents of the report with a few modification. Derivatives, once introduced, will have a significants impact on the fund management methods in India.

While we have been less vulnerable, the South-East Asian crisis has a few lessons for our fund managers. We are increasingly becoming integrated with the international markets. International events can cause volatility in our markets. The impact on our markets could be high as our markets are not all that liquid. It is significant, however,that despite the volatility, foreign investors have remained relatively optimistic on India.

Mutual Funds also need to prepare for capital account convertibility. Indian mutual funds are now being allowed to invest money of domestic investors in overseas markets. This opens up a new avenue. While some may adopt a cautious approach to this new area of investment, I view it as an excellent opportunity to better manage risks and improve returns.

Keeping fund management and distribution expenses low would be a critical success factor for the mutual fund industry. Expenses, as we all know, are eventually paid out by the investor. Operating expenses directly reduce the return that an investor can get from his investment. There is a need to take a closer look at the expense structure of the Indian mutual fund industry. There is also a need to appreciate the real cost of fund distribution in India.

Infrastructure Financing

It is widely appreciated that infrastructure investments hold the key to increased industrial activity. Given the large requirements of this sector, mobilisation of savings by the financial sector would facilitate investments into this sector. This is where pension funds and mutual funds will play an important role. Pension funds mobilise long terms savings, and hence find it attractive to invest in long term securities of infrastructure projects. Mutual funds can also design schemes that could facilitate the transformation of long-term savings into infrastructure investments.

A large proportion of the requirements of the infrastructure sector is in the form of debt securities. Mutual funds need liquid debt markets to design products to meet investor needs. Over the last years, a lot of improvements have taken place in the debt market. Interest rates have gradually become market-determined. We now have nation-wide exchange facilities for trading in debt. There are market makers in the money market, in the form of primary dealers and satellite dealers. Banks, the largest players in the money market, have become more active as Treasury is now seen as a profit-centre rather than just a liquidity-manager. Reserve requirements on inter-bank borrowings has also been removed. Mutual funds now have money market funds in operation. As a result of all these changes, the liquidity in the money market has improved over the years.

However, there is an urgent necessity to improve the liquidity in the corporate debt market. Outstanding stock of corporate debt securities is relatively small, with Government securities accounting for about 75 percent of the aggregate outstanding bond issues of about Rs.4,00,000 crore

(US$ 120 billion). Higher liquidity, will help improve liquidity in corporate debentures.

The corporate debt market segment is yet to see the emergence of full-service brokerage firms. Market making in corporate debt by intermediaries is conspicuously absent. The investor base is narrow and largely confined to banks, state monopolies in insurance and mutual funds as also small financial business firms. But these investors have large portfolios of Government securities and loans rather than tradable corporate debt. Reduction in transaction costs and stamp duties, would substantially reduce the cost of trading in corporate debt, and hence increase their liquidity.

Pension Funds

Management of pension funds offers new opportunities for business expansion for asset management companies. At present, the size of provident funds and pension funds in India is relatively low at about 12 percent of GDP, compared with 67 percent in the US, 55 percent in UK and 39 percent in Australia. As the coverage of provident funds and pension funds increases, this percentage is bound to increase.

The yields under pension/provident funds can be raised substantially through professional fund management. We know that for long term savings, even a small improvement in yield translates into a large benefit for the investor. Further, the prescribed pattern of investment for provident funds and pension funds though liberalised over the last four years, continues to remain relatively conservative. It does not allow flexibility to exploit the potential of higher return even without compromising on safety or risk. In view of this, the overall yield on PF/Pension Funds has remained lower than what could have been achieved.

Globally, mutual funds manage money for pension funds to help them improve yields, by providing a wider range of investments avenues. In the Indian context too, the mutual funds can help the provident funds and pension funds in improving their yields. The risk of investment in corporate debt securities can be reduced substantially by investing in a well diversified portfolio of such securities through mutual funds. Investing in capital market requires expertise and experience in the areas of investment research, dealing in securities and portfolio management. In view of the large amounts involved, such professional advice from mutual funds may also be utilised by provident fund organisations.

Savings for retirement essentially seek long-term growth. For long term growth, investment in equity is desirable. This has been amply demonstrated by the investment experience of pension funds in developed countries like USA, UK, Japan, Canada and Germany, where percentage investment by pension funds in shares and mutual funds has been in the range of 42 percent (in case of Japan) to 71 percent(in case of USA). In the United States, pension funds alone held more than 22 percent of corporate equity in 1995. Coming to Asian examples, the Government Pension Funds in South Korea, Philippines and Malaysia have also significant investment in equities ranging from 9 percent to 11 percent. In India, a beginning can be made by allowing pension funds to invest in equity funds, especially index funds, managed by mutual funds.

Concluding Remarks

The Indian capital market has become more transparent and efficient over the last seven years. The secondary market has vastly improved in terms of both the regulatory systems and market practices, leading to a substantial reduction in risks and transaction costs. SEBI has intoduced prudential guidelines for all the segments of capital markets. The market infrastructure has also improved substantially, bringing it closer to the international standards with the introduction of screen-based trading facilities in many of the country's exchanges. Margining system is now better implemented, and defaulting members are not allowed to continue trading. Stock exchanges have strengthened their internal operating practices, surveillance systems and infrastructure. Stock brokers and merchant bankers, are now better capitalised, professionally organised and more accountable.

As a consequence of all these improvements, the cost of transaction has come down substantially. As per an estimate, the total cost of transaction in the secondary market has already come down from an average 5 percent prevailing in 1991 to an average of 1.5 percent now. Once the depository segment of the exchanges becomes more active, the transaction cost is likely to come down to 0.5 percent within a few years.

Lower transaction costs will lead to greater activity in fund management as the cost of portfolio turnover will come down substantially. This will help fund managers deliver better returns to investors. Higher portfolio turnover by institutional investors will also add to the liquidity in the equity markets.

Liquidity in the non-specified group also needs to improve. Market making holds the key. London Stock Exchange has a quote driven system for mid-cap and small-cap scrips, and an order-driven system for large-cap scrips. In their experience, order-driven system does not work in case of these scrips. In India too, there is a need for a suitable system of market making for the mid-cap and small-cap scrips. I expect that market making in illiquid but potentially good scrips will gather momentum soon.

SEBI has permitted securities lending facility. A few intermediaries have already got registration to carry on the business. Once securities lending takes off, fund mangers will be able to lend idle securities and earn higher returns on the funds. Lending activity will also greatly contribute for the efficiency of the capital markets by infusing liquidity in the market.

In the light of the growth prospects of the Indian economy and the vastly improved capital markets environment, I am optimistic about the future of fund management industry in India. There is a need to have a clear perspective on the available strategic choices and policy options to ensure that the fund management industry is able to achieve high growth and thus contribute to higher capital formation and economic growth.

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