# Distribution of Mutual Funds-Challenges & Opportunities


**Nilesh Shah**
*Managing Director*
*Kotak Mahindra Asset Management Co.Ltd.*

Let me state at the outset: financial intermediaries are the engine oil that makes the financial system roll smoothly. There is an important economic role that MF advisors performs. Distributors create time, place and information value for the Mutual Funds; and for the investors. Without the advisor, each investor/customer would have to develop financial expertise across the financial spectrum, analyzing hundreds of investment choices, thousands of investment products and multiplicity of processes. On the other end, the Mutual Fund would need to be present and available at every nook and corner, raising the cost of the product.

Distributors bring in that specialty. They take away the stress of distribution of products, away from the Mutual funds; allowing them to concentrate on creating performance. On the other hand, distributors bring to investors the knowledge, the information and the ideas about the financial products. This relieves the burden on the investor who otherwise would have to become an expert financial analyst of almost all financial domains to create a well rounded portfolio for him/herself. Therefore distribution community's value-add; this service; is so important that most of the regular investors almost entirely operate on the trust of their distributors. This is an important role. A sacred covenant.

But, I believe that the mutual fund distributor still gets under-appreciated and under-remunerated for their services. Look around and you will find industries and segments where the distribution creates and steers industries.

Take the medical industry for example. An absolutely critical component in any country. And yet.Despite the social necessity of the product, the system is completely ok with the cost of distribution margins. Companies offer about 20% as margins to the distribution channel for selling their products..

For that matter, in the real estate sector, where investors' original sum is only around 10-20% of the total purchase value, the real estate broker gets paid at around 2-4% of the leveraged capital. This translates to around 15-20% brokerage on the investors' capital and the purchaser makes the payment of the brokerage directly to the broker. Something that has not caught on within the Mutual funds distribution.

So it is evident. The Mutual Funds distribution is under-remunerated vis-à-vis their counterparts. This is definitely a challenge. The distributor is expected to attract talent, provide services and still get paid in basis points. It's like asking for Five Star Hotel service at Udipi restaurant rates.

Another issue with the mutual fund brokerage business is that no really owns or directs this distribution industry. We have multiple agencies doing different roles. But we do not have an agency with regulatory recognition to further the agenda of overall development of the mutual fund distribution. The fact is, due to this absence of formalized platform, the industry is fragmented. For this reason, the interests of the distribution community tend to get underrepresented.

We must also appreciate that the scope of work for a mutual fund distributor is vast and challenging. There are around 44 mutual funds in the industry, around 11 broadly defined asset categories, with around 2300 products, with nearly each of it offering atleast 2 sub plan types. And the distribution is expected to have awareness about all of them. That is a huge huge task.

To top that, the distributor is expected to have a functional knowledge of the financial markets. This encompasses knowing about most of such factors that might be affecting the performance of major asset categories, namely equity, debt and gold.

But it doesn't stop at that, the distributor must also be able to distill that knowledge and pack it in easily digestible packets for the end investor. This places a substantial demand for knowledge, reading and communication on the part of the distributor: leaving the distributor exhausted.

Yet, the impact of the volatilities of the market on the investor; and the distributor still cannot be accounted for. At each cyclical downturn, the distributor is again placed back at square one. The distributor must again begin to re-approach the investor relationships from near zero market faith levels, and re-comfort and re-establish the investor's faith in the market.

At that, the back-end process of filing for investments, redemptions etc are a tedious task. There is no straight-through processing which allows for swifter and more efficient method of investment. This creates establishment, time and manpower cost for the distributor.

To top that, the distribution industry is seeing a transformation in its business model. The regulatory directions seem to have an end state in mind. It is to make the mutual fund industry pull driven. As per this idea, the investor is expected to realize and recognize his/her financial investment needs and and then direct the mutual fund distributor to enable the investment. In exchange, for this service, the investor may pay advisory fees to the distributor directly.

The issue is, per this model, the onus and weight of analyzing the markets, and appreciating the portfolio needs, is with the investor. In a country with abysmal financial literacy and understanding, investor education is a long term solution to enable this outcome. For now, the advisor/distributor will continue to have to assume that specialist role; and without the sufficient recognition and remuneration from the investor. It's all the more challenging because the customer is not in the mindset to pay the upfront advisory fees to the mutual fund distributor.

But let us not be bogged down with the challenges.

We belong to a financial sub-sector that is expected to grow faster than most of the industries; and that too in an economy that is itself expected to be the next global growth engine. For example: a study carried out by CRISIL Research indicates that the AUM of the Mutual Fund distributors may triple to Rs 23 lakh crore by 2020; from the present figure of Rs 8 lakh crore. This translates to around 20% CAGR. Most of these gains are expected to be from inflows from HNIs and retail investors into equity mutual funds.

It doesn't surprise me. As the gold sector slackens, and as the real estate inventory piles up, the investment performance of these physical asset classes will come under pressure. In the similar duration, the performance of equity assets has created a class of satisfied investors. These equity investors are not just bringing in more investments, but are also spreading the word around. We believe that as the wealth potential of the Indian equities begins to root in, more and more investors will choose to switch from acquiring physical assets to financial assets. This trend is also in keeping with similar phenomenon observed in other markets, globally.

What also works in favour of the mutual fund distribution community is the fact that trail commission continues to aggregate to the nominee of the distributor. Infact the process has been eased further to avoid any hassles for the nominees later. This creates an inter-generational incentive to build and consolidate the gains made by the elder generation. This may to some extent, again begin to involve the next generation of the distributors into business, who otherwise are not joining their family's MF distribution business on account of the challenges.

As I see it, some of the challenges can be scaled were the distributor to actually become a wholesome provider of financial services under a single roof. This way the distributor can cater the investor across the entire spectrum of investment services, and not lose the opportunity to competitors from other financial sub-segment.

More importantly, the distributor would be able to create a wholesome financial profile for the investor rather than provide services in piecemeal transactions. Additionally, the distributors revenue stream can get re-structured. They can get high inflows by means of sales from other financial products in the short term. On the other hand, Mutual Fund sales can help create an AUM that will provide incremental and compounding revenue inflows for a longer period of time. This will create a balanced revenue stream.

In conclusion, the future success of distributors would be dependent on obtaining the long term involvement of the investors. This would imply advising the investor on the merit of the fund performance; rather than on the strength of the brand. The distributor would also have to become risk sensitive for their investors. Distributors would have to begin to measure whether the funds they are selling are assuming prudent risk necessary to generate performance for their investors. This is because; only a risk-justified return would enable a satisfied long term investor and a successful distributor.