Is Retail finally an integral part of the Fund Industry?

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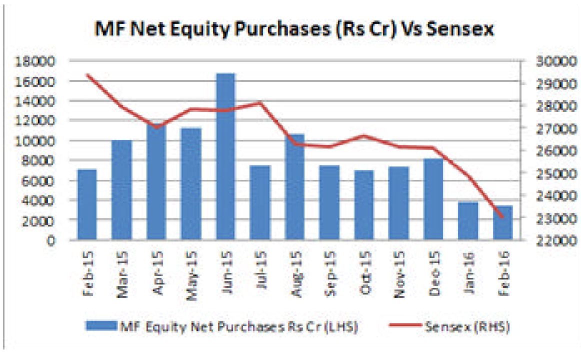
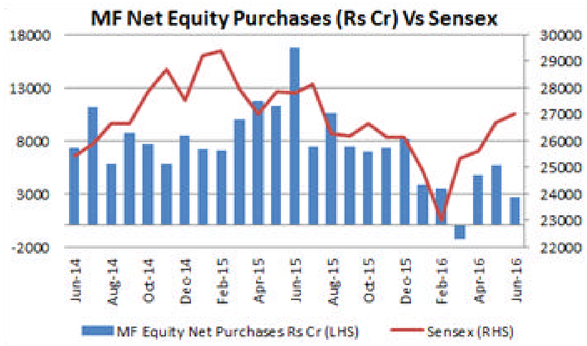
Brexit was a major negative event for the global capital market when investor wealth took a hit of nearly Rs 1.8 lakh crore in the Indian stock market while the overall loss for world markets was estimated at around $2.5 trillion for the day. The S&P BSE Sensex dropped by over 600 points or a 2.24% on June 24, 2016 (intra-day fall of nearly 1100 points). Surprisingly, the reaction from retail investors was contrary to the typical knee-jerk reaction when most would sell equity. The Indian mutual fund industry reportedly saw a substantial rise in transactions from retail investors who used the sharp correction as a buying opportunity. The media reported that there was nearly a 5-fold rise in number of transactions spanning across systematic investment plans (SIP), lump sum investments and new purchases. There was a similar reaction on the stock exchanges wherein retail investors bought shares worth Rs 118 crore, the highest for a day so far this fiscal. Here too retail investors took a contrarian call by turning net buyers.

These are not isolated incidents that took place only on June 24. If we analyse the period 29-Jan-2015 to 11-Feb-2016, the Sensex went into a deep dive from a peak of 29681 to 22951 - a 23% drop mainly on concerns over corporate earnings growth. Despite this steep fall, mutual fund investors kept their faith and made net equity purchases of Rs.1.12 lakh crore during the period February 2015 to February 2016 (see graph) averaging Rs.8623 crore per month (over a billion dollars). In fact, over the past 24 months (July 2014 to June 2016), there was only one instance (month) where mutual fund net equity purchases were negative (March 2016). Overall, these investors (predominantly retail) made net equity mutual fund purchases of Rs.1.86 lakh crore in this period (average Rs.7750 crore per month).

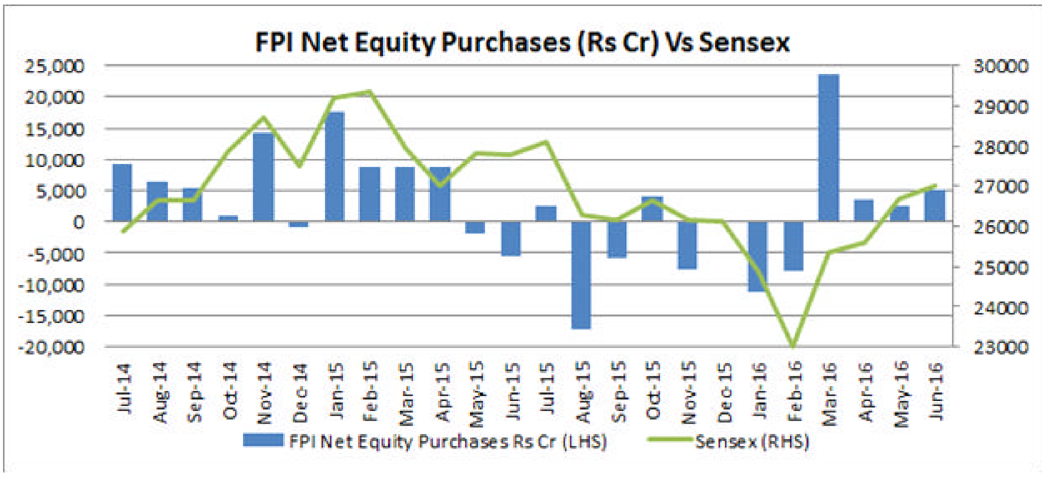


Source – AMFI (includes balanced funds); Graph period (Feb 15 – Feb 16)



Source – AMFI (includes balanced funds); Graph period (Jul 14 – Jun 16)

While retail investors were on a buying spree, FPIs (foreign portfolio investors), on the contrary, net sold equities in 8 out of 24 months between July 2014 to June 2016 (see chart). They made net purchases of Rs.64,539 crore in this period, which is only about a third of the net purchases made by mutual fund equity investors. The latter clearly appear to have matured over the years by setting an example of opportunistic buying during panic times (unlike what we saw post 2008). They have also played an important role over the past two years by not only countering a pullout by FPIs but also helping to trim the fall in the benchmark indices.

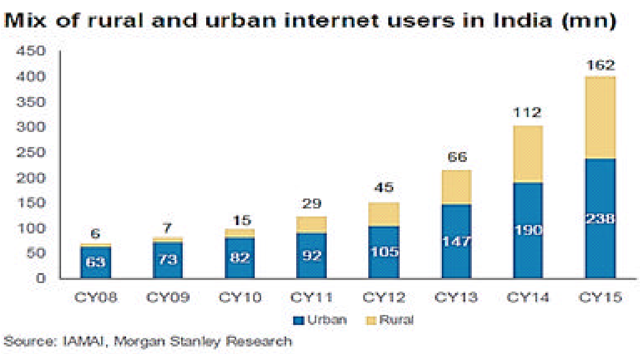


More evidence of the retail trend is also seen in SIP numbers (which are a good representation of retail influence) whose count crossed the 1 crore mark in April 2016. This is a 35% YoY growth from 73 lakh as of March 2015. Thus the industry has added more than 25 lakh SIP accounts over the past year at an average of 2 lakh SIPs per month. With SIP flows aggregating about Rs.3000-3500 crore per month, the average ticket size works out to a decent Rs.3000 per SIP. Mutual fund folios (which include both SIP and lumpsum purchases) too added more than 60 lakh accounts in the past 12 months contributing an average of 5 lakh folios per month.

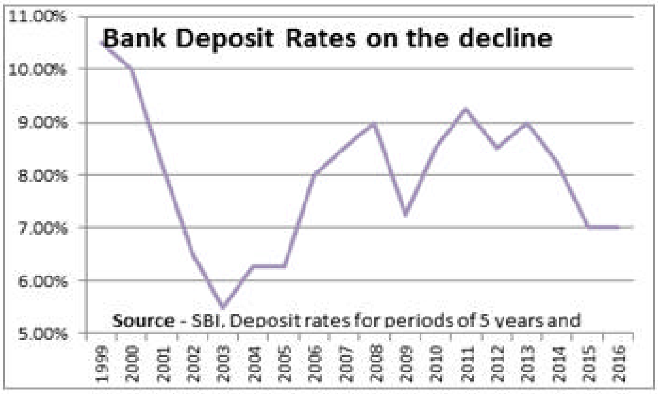
Reasons for the change in retail mindset

Clearly the change in the retail mindset has not been smooth a transition and is mainly the result of consistent efforts from manufacturers and distributors on the investor education front. A big push to these efforts came in October 2012 when SEBI directed mutual funds to allocate 2 basis points of their AUM every year to investor education (IE). Though the industry started on a bumpy note with divergent messages being sent to investors across AMCs while trying to spend the investor education corpus, it has now become a lot smoother with good cohesion in the recent period when funds focused on SIP as a message in most communication. The IE advertisements/ literature available across physical and digital medium highlighted aspects like consistency and longevity of investments via SIPs besides the benefits of compounding. “Do not time the market”, “Time in the market is more important than timing the market” are some of the common punch lines used in these communications. The stress on stickiness of investments to benefit from the higher returns potential of equity funds over the long run has clearly benefited the industry and investors as seen in the SIP numbers cited above. Currently, at an AUM of about Rs.14 lakh crore, the investor education corpus stands in the range of Rs.280 core, half of which is now being spent by the industry association AMFI or Association of Mutual Funds in India.

The second major contributor to this change has been technology especially digital media which has enabled investors to exercise a call to action in a quick and seamless manner. Earlier, despite seeing an advertisement, there was lethargy to invest owing to procedural bottlenecks as well as the paperwork involved. Today, technology has been able to connect most of the dots and an advertisement can lead to a purchase within a few seconds and a few clicks. Even the complicated process of KYC has been smoothened by using Aadhaar as an enabler for authentication. This has largely been complemented by the fast penetration of the internet (see chart) and affordability of smart phones both of which have helped make mutual fund investments location, time and device agnostic.



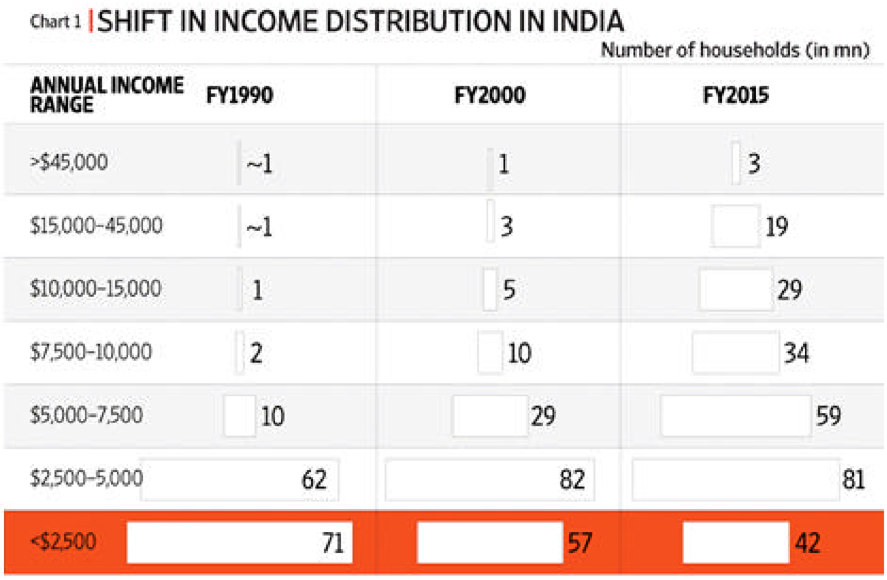
The third key contributor to retail growth has been the fall in interest rates (see chart) which have come a long way from the double digits rates available in the 90s. Many savers have realised that the real rate of return (interest rate less inflation rate) on their bank deposits is on the decline leading to a short-fall while planning for their life goals. This has led them to search for investment products which can offer relatively higher inflation adjusted returns. Mutual funds fit the bill as they can match various risk appetites and return expectations besides offering tax efficiencies. The returns from the CRISIL-AMFI Equity Fund Index (representative index for equity funds) indicate the earnings potential from equity funds over the long run. One can also choose other categories of mutual funds based on their investment horizon, risk appetite and return expectations.



Index	1 Year (%)	2 Year (%)	3 Year (%)	4 Year (%)	5 Year (%)	7 Year (%)	10 Year (%)	15 Year (%)
CRISIL- AMFI Equity Fund Performance Index	3.36	9.51	20.93	17.32	12.50	14.35	13.65	20.77
Nifty 50	-0.96	4.34	12.33	11.92	7.96	9.85	10.22	14.34
S&P BSE Sensex	-2.81	3.07	11.62	11.55	7.45	9.29	9.78	14.67
Nifty 500	1.21	6.32	15.62	13.72	9.06	10.49	10.53	16.27

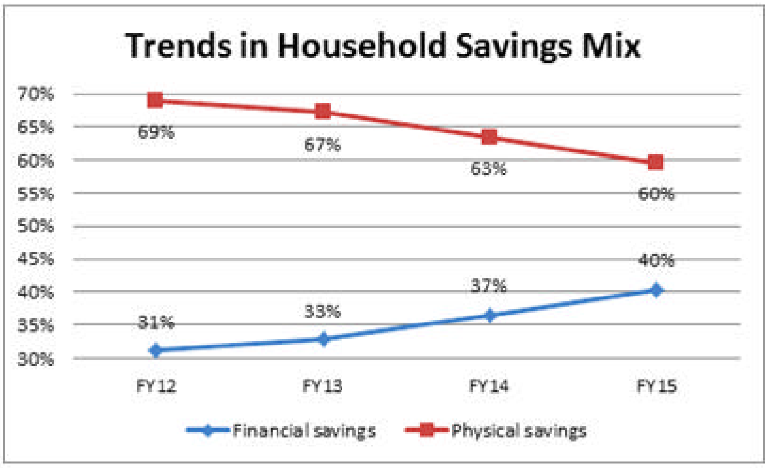
Returns as on June 30, 2016. Returns for period greater than one year are annualised

The next contributor is rising middle class income levels with India seeing a big shift in incomes of its population from lower than $5,000 annual income to higher levels over the last 15 years (see chart). A number of factors are likely to grow the middle class over the next two decades. First, the proportion of people in the workforce has risen and will continue to rise considerably with 65% of India currently below 35 years of age. Second, the country has seen steady urbanization over the past years, bringing a major shift in the labour market from agricultural jobs to better-paying manufacturing and service jobs.



Source – Livemint http://bit.ly/21buMIb

The fifth important contributor is the shift of household savings from physical to financial savings mainly due to the rise in ticket size of real estate and gold besides lack of regulations for both. Real estate also suffers from lack of liquidity. The graph below indicates that the shift, though gradual, is happening at a steady pace. Currently, investors who enter mutual funds cross two levels of hurdles – first is the shift from physical to financial savings, second is the shift from assured returns financial savings to market linked financial savings like mutual funds. The second hurdle is more difficult to cross than the first hurdle.



Source – Ministry of statistics

Plenty of opportunities to expand the retail pie

Though we as an industry are on the right track, I would still call it the tip of the ice-berg as equity AUM (including balanced funds) still stands at Rs.4.74 lakh crore as of June 2016 while the long term mutual fund assets (ex-liquid funds) stand at Rs.11.36 lakh cr. This is less than half the assets under management (AUM) of the insurance industry at Rs.25.29 lakh crore as of March 2016 (Source – Life Insurance Council). If we look at the banking space, we have Rs.23 lakh crore lying in savings bank accounts earnings 4% per annum and another Rs.57 lakh crore in term deposits, together aggregating Rs.80 lakh crore as of March 2015 (Source – RBI). A roughly 10% addition over the last one year would mean the figure is close to Rs.90 lakh crore. Small savings (mostly postal deposits) aggregate another Rs.6.5 lakh crore as of March 2015 (Source – RBI). So we have a retail audience who has close to Rs.100 lakh crore of savings in assured returns products. Even if 5% of this can be converted to mutual fund investments every year we are looking at a Rs.5 lakh crore opportunity per annum !

However, as I have mentioned earlier, crossing the hurdle from assured returns to market linked returns is not going to be easy as most Indians are risk averse. Hence, it is important to ensure that investors enjoy a smooth transition. So why not look at liquid and ultra short term debt funds for risk-averse investors. We need to display the opportunity lost by parking over Rs.23 lakh crore of deposits in savings bank accounts @ 4% p.a. instead of liquid funds which currently earn over 8% annualised returns (see table).

To start with, individuals may be provided with an option to transfer salaries directly to liquid fund accounts with the collaboration of employers and concurrence of employees (an enabling regulation could also help). Currently, only 2% of the liquid fund AUM is retail while about 12% belongs to individuals (retail and HNIs). This can swell manifold, if retail investors are provided educative inputs about this category via their employers. For illustration purposes, if Rs.23 lakh crore is parked in a savings bank account @4% p.a., it would yield approximately Rs.92,000 crore interest in one year. This could earn double the returns or Rs.1.86 lakh crore if parked in a liquid fund @8.07% based on the CRISIL-AMFI Liquid Fund index. Think again, even e-wallets, mobile phone and other prepaid card balances could be funneled into liquid funds like is done by Alibaba through Alipay !

Index	1 Year (%)	2 Year (%)	3 Year (%)	4 Year (%)	5 Year (%)	7 Year (%)	10 Year (%)
CRISIL - AMFI Money Market Fund Performance Index	8.17	8.47	8.77	8.79	8.88	8.00	7.94
CRISIL - AMFI Liquid Fund Performance Index	8.07	8.41	8.76	8.76	8.85	7.90	7.82
CRISIL - AMFI Ultra Short Fund Performance Index	8.37	8.61	8.87	8.88	8.97	8.10	NA
Savings Bank Rate History	4.00	4.00	4.00	4.00	4.00	3.50	3.50

Returns as on June 30, 2016

Returns for period greater than one year are annualised returns

The second big opportunity for retail AUM to gallop is the ease of KYC norms through central KYC (live from July 15, 2016) wherein a single KYC would suffice for all financial products. In other words, a bank KYC would also be valid for a mutual fund. This will provide huge operational convenience to the distribution community to onboard investors. For example, if one family member is a folio holder, the c-KYC convenience may lure him to open mutual fund accounts for all family members who have a bank account.

Last but not the least, the industry needs solutions not products for the retail investor. The insurance industry has reached an AUM of over Rs.25 lakh crore by only offering solutions. For example, with longer life spans (thanks to advancement in medical science), retirement solutions is one big area which is not fully explored. Currently, the government operates the EPF (Employees Provident Fund) and the National Pension System (NPS) in this space while insurance and mutual funds too have some relevant products. According to CRISIL, only about 8% of the country's working age population is currently covered by social security while penetration of retirement products remains way short at 10% of GDP compared with an average 84% in 16 major pension markets of the world. Though SEBI had proposed the MFLRP or Mutual Fund Linked Retirement Plan, the same is yet to take off for lack of regulatory support. India would need an equivalent of the US based 401(K) plans offered by employers or IRAs (Individual Retirement Accounts) to narrow the pension gap. Besides retirement solutions, there could also be education solutions, real estate solutions, vacation solutions and so on.

Closing Remarks

There was a time when investors preferred direct equity over mutual funds. This was seen by the higher number of demat accounts opened vis-à-vis mutual fund folios. Times have now changed in favour of mutual funds with latest numbers showing that over the past year more than 60 lakh folios were opened by mutual funds till June 2016. In comparison, NSDL and CDSL combined opened only about 30 lakh new demat accounts – less than half the number of new mutual fund folios. Even at an aggregate level, India has just over 2.5 crore demat accounts vis-à-vis nearly double or ~5 crore mutual fund folio accounts.

Why are these numbers diverging so quickly? Firstly direct investment in stocks through a demat account is only meant for seasoned professionals who invest in thoroughly researched stocks. The rest follow the mutual fund route where portfolios are managed by professionals who have decades of experience and are backed by a strong research team. They have seen multiple market cycles and have a deep understanding of the sectors and the companies that they invest in. Regular interactions with the company's management are also a key ingredient in the decision making process. Individual investors would not have the wherewithal to choose companies in this manner and hence they opt for mutual funds.

All this provides a clear direction that retail investors are an integral part of the fund industry and are surely into mutual funds for the long haul.