# Small Investors Orientation for Mutual Funds

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Despite India's century old stock exchange and long history of private banks, the financial system intermediates a small amount of assets relative to the size of the economy. This can be seen from India's 'Financial Depth' or value of financial assets relative to GDP, which is significantly lower than in other fast growing Asian economies. Infact much of the saving and investment fueling India's GDP growth goes on outside India's formal financial system. Indian households save more than thirty percent of their disposable income, but invest only half of their savings into bank deposits and other financial assets. They invest another thirty percent in housing and put the remainder into machinery and equipment for the millions of tiny household enterprises that make up India's 'unorganised sector' (source: Mckinsey report). Also, Indian households are the world's largest consumer of Gold, another form of non-financial saving. The Indian economy would grow faster if the financial system can capture more of the country's savings and channelise them into more productive enterprises.

## 1. ROLE OF MUTUAL FUNDS

If India has to be domestic financial powerhouse, then higher retail participation in the financial markets is a must. And Mutual funds are the best growth drivers to ensure this as they allow even the small investor to invest in the growth potential of not only the Equity markets but also the Debt markets.

However, despite the industry being opened to private and foreign players for the last 15 years, the growth of the Mutual Funds has been slow. According to a McKinsey Study, Asset Under Management (AUM) of mutual funds as percentage of GDP in India is 8% as against 79% in US, and 39% in Brazil.

This situation seems to be improving. Mutual Fund industry has witnessed healthy growth in the year 2007 – 08 with the average AUM of the Industry increasing from Rs. 3,56,835 crores as at 31st March 2007 to Rs. 5,28,857 crores on 31st March 2008, a growth of 48% (source: AMFI). The worrying factor is that retail participation in mutual funds has still some way to go.

## 2. NEED FOR REFORMS

2.1. **The Retail penetration of Mutual Funds:** Though Mutual Funds have done considerably well in the last one year in terms of retail participation, the penetration of Mutual Funds beyond tier II cities is very low. Mutual Funds have so far remained an urban phenomenon and barring a few Mutual Funds not many have attempted to reach the hinterland of India. Data from CDSL Ventures Ltd. (CVL), which has been entrusted the work of completing the Know Your Customer (KYC) guidelines for Mutual Fund investors, shows that, of the total applications received, 45% applications are from Mumbai, Delhi, Kolkata, Chennai and Bangalore. Another 25% come from large cities and 20% from smaller cities and semi urban areas. In order to make Mutual Funds the preferred investment avenue for the masses, reforms are necessary.

2.2. **Holding by Retail Investors:** The data available on the breakup of the net assets held by individuals show some stark results. As of 31st March 2007, Individual investors hold only 42.35% of the net assets of the Mutual fund industry. As of March 31, 2007, of the bigger Fund houses only UTI Mutual Fund has more than 75% of its net assets held by individual investors (source: SEBI).

2.3. **Cost of Mutual Funds:** The revenues and profits of Indian Asset management companies are relatively small as compared to other developing and developed countries. The revenues of Indian fund houses is USD 0.5 billion and pre tax profits are USD 0.2 billion as compared to USD 12.6 billion and USD 3.9 billion in UK, USD 6.2 billion and USD 2.2 billion in Brazil and USD 2.2 billion and 0.5 billion in China. However, the Indian Mutual Fund industry's operating profit as a percentage of average AUM is higher at 32 bps as compared to 12 bps in UK and 18 bps in US. This is despite the case that the cost structure in India is higher than in most economies (source: McKinsey report).

2.4. **Evolving Customer needs:** Though Indian Asset Managers have so far taken limited international exposure, the sub prime crisis has made the investor aware about the need for transparency on products and processes. Fund houses will need to cater to this need and will be required to reinforce their risk management control systems. Also, even as customers demand better returns they want lower risk. Therefore as Indian Fund managers look to launch more complex products involving derivatives, regulatory controls need to be in place.

## 3. REFORMS

SEBI has taken several initiatives recently that will help the mutual fund industry to significantly increase efficiencies. Notable among them are rationalizing and reducing the fees charged for filing offer documents for mutual funds and simplifying offer documents of mutual fund schemes. Mutual fund offer document will now be in two parts-one containing all information on the specific scheme (Scheme Information Document) and the other containing all other general information (Statement of Additional Information).

Significant investor friendly initiatives include increasing the prescribed time for risk warnings in mutual fund commercials from two seconds to five seconds, and introduction of Real Estate Mutual Funds or REMFs. REMFs allows retail investors to take advantage of opportunities in the real estate through professional investing by mutual fund managers, rather than investing in real estate directly with its attendant hassles.

But a lot still needs to be done.

A few reforms that should help the mutual fund industry are:

**3.1. DOING AWAY WITH THE REGULARIZATION OF EXPENSE RATIOS, ENTRY LOADS AND EXIT LOADS:** Expenses incurred by a mutual fund in launching or maintaining a fund should be decided by the fund houses themselves. With increasing number of players and varied product offerings, the market dynamics would take care of regularizing the fees. If some fund is charging a higher fee, the investor can decide whether he finds the performance of the fund justifying its expenses and fees. It has been proven that in markets with multiple players, price discovery should best be left to the market itself. The competition will automatically ensure downward trend of costs.

**3.2. REMOVING THE LIMITS ON OVERSEAS INVESTMENT BY MUTUAL FUNDS:** In this era of globalization any effort to curb transparent flow of money beyond borders may be a regressive step. There are excellent capital market and alternative investment opportunities in other emerging markets like China, Brazil, Taiwan and developed markets like UK, US that should be made available to the Indian investors. And the best way to channelise the investors money would be through Mutual Funds. Thus as the fund houses are increasingly looking to explore themes like emerging markets, global commodities etc, investment restrictions should be done away with completely.

**3.3. ALLOWING MUTUAL FUNDS TO INVEST IN VARIOUS ASSET CLASSES:** Restrictions on direct investments in commodities is another point of contention. While funds abroad do not have such restrictions, Indian fund houses face restrictions on the same. Thus while the fund houses launch commodities fund, in effect they become funds which invest in companies that are related to commodities business, for example, a gold fund would invest in a gold mining company but cannot invest directly in gold (except for ETFs). Such restrictions in a progressive market like India, deprive investors of the opportunities that can be exploited in the commodities market.

**3.4. ALLOWING PENSION FUNDS / PROVIDENT FUNDS TO INVEST THROUGH MUTUAL FUNDS:** Investors run the risk of misuse of investor corpus if professional fund managers do not manage the fund. Individuals who are not experts in managing funds manage many exempt provident funds. This may reduce the potential return that an investor may have otherwise got from his investment. This can also lead to losses. Mutual Fund Managers who have the capabilities to invest for long duration with proper risk return management are the best people to manage such investments.

**3.5. TIED AGENTS:** Mutual Funds agents, unlike Insurance companies, do not work for a single mutual fund company. This can lead to conflict of interest with the agent pitching for products, purely based on higher commissions rather than keeping the investor's interests in consideration. Also, Fund houses that provide a lot of training and certification to the agent at their own cost often find that agent selling for other fund houses. This reduces the incentive for a Fund house to provide training to any financial advisor. The issue can be resolved if, like Insurance companies, Mutual Funds also have a tied Agent system.

**3.6. CONCEPT OF FINANCIAL PLANNERS:** One thing that has still not germinated as a concept in India is that of Financial Planners, i.e. advice given with the interest of the investor in mind rather than interest of the Advisor or the Fund house. The financial services industry deals in the manufacture and distribution of financial products. A financial consultant can be considered similar to a doctor – someone who diagnoses a problem, prescribes a solution and ensures future good health and a distributor of financial products is analogous to a chemist – who can only give the medicine which is prescribed by the doctor. But in financial products this boundary is often not clear. If the chemist starts prescribing medicine without understanding the health of the investor then there will be major complications. Mutual Funds need to take the lead in developing the concept of separate Distributor and Advisor. An advisor should be the one who will give advise to a person for a fixed fee, without actually recommending a specific product to him. The investor based on the advice can consider investing in any product of his choice based on his preferences.

**3.7. SIMILAR REGULATIONS FOR SIMILAR PRODUCTS:** Traditionally insurance companies were looking to provide insurance solutions for life and assets to an investor, while mutual funds would concentrate on provide investment solutions to an investor. However in the last few years, insurance companies have increasingly looked to provide investment services to investors under the 'ULIPs'. This has reached a proportion where insurance companies are only concentrating on selling ULIPs as compared to traditional insurance plans. Many retail investors have also started looking at ULIPs as part of their investment portfolio. However as ULIPs of insurance companies are much more expensive with high fees and loads, they lead to much lower returns to the investors when compared to mutual funds. However, investors are still mis-sold ULIPs as insurance companies pay much higher commission to their agents. Also, India being a icon driven country, celebrity endorsements for ULIPs create an immediate positive impact for ULIPs. The tax regime is also in the favour of ULIP with even debt investment for ULIPs being tax – free as compared to mutual funds where debt investments are taxed.

To ensure that investors interests are well protected and that investors money generates the best return for them, similar regulations for these similar investments must be ensured. This will provide level playing field to all players in the financial services while ensuring proper growth.

**3.8. FINANCIAL LITERACY AND INVESTOR EDUCATION:** India is in an environment of change and the form and complexity of the financial transactions is increasing. The world for the consumers is also becoming increasingly complex, with new forms of investment and the taxation structure that comes along with it, being introduced. It is common knowledge that financial literacy amongst adults, parents and younger generation is insufficient to cope up with these complexities. Financial literacy, therefore becomes very important. An ordinarily educated person in India has no occasion during his school or college days to get exposed to financial terminology, its significance in his day to day life and the issues involved in the financial markets. Ignorance in this area often leads to investment decisions confined in traditionally 'safe' investments, without appreciating the inherent risk and the risk return trade-off in these instruments. Vast majority of the Indian Retail investors, therefore end up not availing the advancement in the financial markets or growth in the economy, not by design but by ignorance and fear of the unknown. Naturally, the risk mitigation through Institutional or systematic investments is also alien to them.

All the Fund houses need to come together to create a common pool of resources, one that would be directed towards educational programmes. The idea is to collect talent and, importantly, money, for educating investors, especially the small investors. What is needed is a unified effort to fight the industry's worst enemy - ignorance about mutual funds. Mutual Fund industry should also contribute its own money towards creating investor awareness - which will help them in a long run if the market is deepened. For example, a small percentage of the Asset Management fees earned by the Fund Houses annually, say 0.5%, can be levied for this purpose.

**3.9. OUTSOURCING OF FUND MANAGEMENT BY INSURANCE INDUSTRY TO MUTUAL FUNDS**: Qualified Fund Managers are a scarce resource in India. Thus, as the number of fund houses has increased, the demand for the Fund Managers has spiraled leading to a high cost of Fund Management. In such a scenario, to provide economies of scale, it makes prudent sense to combine the fund management for Mutual Funds and Insurance. Also as the demand for income generation and risk protection product increases, Insurers and Mutual Funds will have to come together. Most Fund houses do not possess the balance sheet strength or the risk management expertise to develop and price risk-mitigation products. Insurers, similarly, do not have either the reputation or asset management skills to successfully manufacture investment products. The outsourcing of fund management by the Insurance industry to Mutual Fund can open up USD 175 billion in AUM.

## 4. CONCLUSION

The Mutual Fund industry in India has developed into a successful and sophisticated model under the careful supervision of SEBI over the years. While some reforms were slow to come, we all should appreciate some bit of conservatism was imperative for proper regulation and minimising manipulation of this small but fast growing emerging market. However, now that the Indian market has grown to a decent size and that the world has started taking interest in the Indian markets, the reforms need to be more radical and free-flowing. And the changes should not only come from the regulatory body but also from within the mutual fund industry.

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