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1. INTRODUCTION

1.1 Definition of a Mutual Fund

There are various investment avenues available to an investor such as real estate, bank deposits, post office deposits, shares, debentures, bonds etc. A mutual fund is one more type of investment available to investors. There are various reasons investors prefer mutual funds.

Usually, buying shares directly from the market requires spending time to find out the performance of the company whose share is being purchased, understanding the future business prospects of the company, finding out the track record of the promoters and the dividend, bonus issue history of the company etc. An informed investor needs to do research before investing. Investors, many a times, find it cumbersome and time consuming to scrutinize so much of information, get access to so much of details before investing in the shares. Investors therefore prefer the mutual fund route.

A mutual fund is a pool of money that is managed on behalf of investors by a professional money manager. The manager uses the money to buy stocks, bonds or other securities according to specific investment objectives that have been established for the fund. In return for putting money into the fund, one will receive either units or shares that represent his or her proportionate share of the pool of fund assets. In return for administering the fund and managing its investment portfolio, the fund manager charges fees based on the value of the fund's assets.

A mutual fund is a type of investment fund. An investment fund is a collection of investments, such as stocks, bonds or other funds. Unlike most other types of investment funds, mutual funds are usually "open-ended," which means as more people invest, the fund issues new units or shares.

An investor in a Mutual Fund Scheme receives units which are in accordance with the quantum of money invested by him. These units represent an investor's proportionate ownership into the assets of a scheme and his or her liability in case of loss to the fund is limited to the extent of amount invested by him.

The pooling of resources is the biggest strength for mutual funds. The relatively lower amounts required for investing into a mutual fund scheme enables small retail investors to enjoy the benefits of professional money management and lends access to different markets, which they otherwise may not be able to access.

A mutual fund typically focuses on specific types of investments. For example, a fund may invest mainly in government bonds, stocks from large companies or stocks from certain countries. Some funds may invest in a mix of stocks and bonds, or other mutual funds.

1.2 Reasons for investing in Mutual Funds

When an individual buys a mutual fund, he or she is pooling his/her money with many other investors. This lets one invest in a variety of investments for a relatively low cost. Another advantage is that a professional manager makes the decisions about specific investments.

Also, mutual funds are widely available through banks, financial planning firms, brokerage firms, credit unions, trust companies and other investment firms. One can buy or sell funds at any time. Benefits of investing in Mutual Funds are.

- ✓ **Diversification:** Investing in a number of different securities helps reduce the risk of investing. When a mutual fund is bought, one is buying an interest in a portfolio of dozens of different securities, giving an instant diversification, at least within the type of securities held in the fund.

  Mutual funds can make it easy and affordable to own a variety of investments. Not all investments perform well at the same time. Different investments react differently to world events, factors in the economy like interest rates, and business prospects. So when one investment is down, another might be up. Having a variety of investments can help offset the impact poor performers may have, while taking advantage of the earning potential of the rest. This is called "diversification."
- ✓ **Affordability:** With many mutual funds, one can begin buying units with a relatively small amount of money. Some mutual funds also let one buy more units on a regular basis with even smaller instalments (Systematic Investment Plan).
- ✓ **Professional Management:** Mutual funds are managed by professionals who are experienced in investing money and who have the skills and resources to research many different investment opportunities.

- **Liquidity:** Units or shares of mutual funds can be redeemed at any time.
- **Flexibility:** Many mutual fund companies administer several different mutual funds (e.g., money market, fixed-income, and growth, balanced and international funds) and allow one to switch between funds within their 'fund family' at little or no charge. This can enable one to change the balance of his or her portfolio as the personal needs or market conditions change.
- **Performance Monitoring:** The value of most mutual funds is reported daily in the financial press and on many internet sites, allowing to continually monitor the performance of the investment.
- **Transparency:** The mutual fund industry in India works on a very transparent basis, and various kind of information are available to their investors, through fact sheets, offer documents, annual reports etc.
- **Well Regulated:** Indian Mutual Fund industry is well regulated by the Securities and Exchange Board of India (SEBI). This helps to instil confidence and provides comfort to the investors. The regulatory environment in India is robust, and ensures transparency in the processes and transactions. The best practices adopted by the industry in India have helped them obtain the confidence of investors over the years. The ease and convenience which mutual funds offer and the different variety of schemes made available to the investors creates popularity for mutual funds, which cuts across investor classes and creates a favourable appeal.

In the long run, Mutual Funds commonly benefit an individual. Financial goals differ from individual to individual, but common examples of goals one looks to accomplish are:

- **Retirement:** It is estimated that retirees will need 70 to 80% of their final, pre-tax income to maintain a comfortable lifestyle in retirement. If one plans to retire at age 65, retirement savings should last for at least 18.5 years, as the average life expectancy for a 65-year-old is 83.5, and continues to rise. Ideally, individuals use a combination of sources to fund retirement, and personal savings.
- **Education:** Numerous parents and grandparents use mutual funds to provide for children's college educations. The investor's time horizon is an essential consideration when investing for education. If one starts investing when a child is born, it gives the parent 18 years to invest. However, if a child or grandchild is in the future, the time horizon can be lengthened by investing at present.

- **Emergency Reserves and Other Short-Term Goals:** Emergency reserves are assets one may need unexpectedly on short notice. Many investors use money market funds for their reserves. Money market funds alone, or in combination with short-term bond funds, can also be appropriate investments for other short-term goals.

1.3 Disadvantages of Mutual Funds

Though mutual funds are the most efficient ways to invest, there may be a few hesitations individuals have towards investing in them. They are.

- **No Insurance:** Mutual funds, although regulated by the government, are not insured against losses. Despite the risk-reducing diversification benefits provided by mutual funds, losses can occur, and it is possible (although extremely unlikely) that one could even lose your entire investment.
- **Dilution:** Although diversification reduces the amount of risk involved in investing in mutual funds, it can also be a disadvantage due to dilution. If a single security held by a mutual fund doubles in value, the mutual fund itself would not double in value because that security is only one small part of the fund's holdings. By holding a large number of different investments, mutual funds tend to do neither exceptionally well nor exceptionally poorly.
- **Fees and Expenses:** Most mutual funds charge management and operating fees that pay for the fund's management expenses. In addition, some mutual funds charge high sales commissions, distribution fees, and redemption fees. And some funds purchase and sell shares so frequently that the transaction costs add up significantly. Some of these expenses are charged on an ongoing basis, unlike stock investments, for which a commission is paid only when you buy and sell.
- **Poor Performance:** Returns on a mutual fund are not guaranteed. On average, around 75% of all mutual funds fail to beat the major market indexes, like the Sensex, and a growing number of critics now question whether or not professional money managers have better stock-picking capabilities than the average investor.
- **Loss of Control:** The managers of mutual funds make all of the decisions about which securities to buy and sell and when to do so. This can make it difficult for you when trying to manage your portfolio. For example, the tax consequences of a decision by the manager to buy or sell an asset at a certain time might not be optimal for you. You also should remember that you trust someone else with your money when you invest in a mutual fund.
- **Trading Limitations:** Although mutual funds are highly liquid in general, most mutual funds (called open-ended funds) cannot be bought or sold in the middle of the trading day. You

can only buy and sell them at the end of the day, after they've calculated the current value of their holdings.

- ✓ **Size:** Some mutual funds are too big to find enough good investments. This is especially true of funds that focus on small companies, given that there are strict rules about how much of a single company a fund may own. If a mutual fund has Rs. 50 crore to invest and is only able to invest an average of Rs. 50 lakh in each, then it needs to find at least 100 such companies to invest in; as a result, the fund might be forced to lower its standards when selecting companies to invest in.
- ✓ **Inefficiency of Cash Reserves:** Mutual funds usually maintain large cash reserves as protection against a large number of simultaneous withdrawals. Although this provides investors with liquidity, it means that some of the fund's money is invested in cash instead of assets, which tends to lower the investor's potential return.
- ✓ **Too Many Choices:** The advantages and disadvantages listed above apply to mutual funds in general. However, there are over 10,000 mutual funds in operation, and these funds vary greatly according to investment objective, size, strategy, and style. Mutual funds are available for virtually every investment strategy (e.g. value, growth), every sector (e.g. biotech, internet), and every country or region of the world. So even the process of selecting a fund can be tedious.

1.4 History of Mutual Funds

It is uncertain about how and when mutual funds came into existence. Some historians say that the closed-end investment companies first launched in 1822 in the Netherlands under King William I. Others suggest that it was a Dutch merchant named Adriaan van Ketwich whose investment trust created in 1774 may have given King William I the idea in the first place. Ketwich may have suggested that diversification would increase the appeal of investments to smaller investors with minimal capital. Subsequently, newer mutual funds included an investment trust in Switzerland in 1849, along with similar vehicles created in Scotland in the 1880s.

Great Britain and France soon took to the idea of pooling resources and spreading risk using closed-end investments, followed by its adoption in the United States in the 1890s. The Boston Personal Property Trust, formed in 1893, was the first closed-end fund in the U.S. An important development took place with the creation of the Alexander Fund in Philadelphia in

1907 which introduced the modern mutual fund. The Alexander Fund featured semi-annual issues and allowed investors to make withdrawals on demand.

The creation of the Massachusetts Investors' Trust in Boston, Massachusetts, indicated the arrival of the modern mutual fund in 1924. The fund went public in 1928 which gradually grew into what is known today as MFS Investment Management. State Street Investors' Trust which was the custodian of the Massachusetts Investors' Trust, later founded its own fund in 1924. In 1928, the launch of the Wellington Fund took place which was the first mutual fund to include stocks and bonds, as opposed to direct merchant bank style of investments in business and trade.

By 1929, there were 19 open-ended mutual funds competing with nearly 700 closed-end funds. When the U.S. stock market crashed in 1929, the dynamic began to change as highly-leveraged closed-end funds were shut down and small open-end funds managed to survive.

Government regulators also began to take notice of the fledgling mutual fund industry. The creation of the Securities and Exchange Commission (SEC) in the U.S. put in place safeguards to protect investors. Mutual funds were required to register with the SEC and to provide disclosure in the form of a prospectus.

The mutual fund industry soon continued to expand. At the beginning of the 1950s, the number of open-ended funds topped 100. By 1954, the financial markets fully recovered from the peak of the 1929 crash, and the mutual fund industry began to grow in earnest, adding some 50 new funds over the course of the decade. The 1960s brought in the aggressive growth funds, with more than 100 new funds established and billions of dollars in new asset inflows.

Hundreds of new funds were launched throughout the 1960s until the bear market of 1969 cooled the public appetite for mutual funds. Money flowed out of mutual funds as quickly as investors could redeem their shares, but the industry's growth later resumed.

In 1971, William Fouse and John McQuown of Wells Fargo Bank established the first index fund. The 1970s also saw the rise of the no-load fund. This new way of doing business had an enormous impact on the way mutual funds were sold and would make a major contribution to the industry's success.

The bull market of the 1980s and '90s made the previously obscure fund managers into superstars. More recently, the burst of the tech bubble and a spate of scandals involving big names in the industry took much of the shine off of the industry's reputation. Suspicious dealings at major fund companies demonstrated that mutual funds are not always benign investments managed by folks who have their shareholders' best interests in mind.

Despite the scandals that surfaced in 2003, and the global financial crisis of 2008-2009, the story of the mutual fund is far from over. In fact, the industry is still growing. In the U.S. alone there are more than 10,000 mutual funds, and if one accounts for all share classes of similar funds, fund holdings are measured in the trillions of dollars. Despite the launch of separate accounts, exchange-traded funds and other competing products, the mutual fund industry remains healthy and fund ownership continues to grow.

1.5 Mutual Funds in India

Unit Trust of India was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up mutual funds. In the year 1992, Securities and exchange Board of India (SEBI) Act was passed. The objectives of SEBI were to protect the interest of investors in securities and to promote the development of and to regulate the securities market.

The history of mutual funds in India can be broadly divided into four distinct phases.

- ✓ **First Phase** – 1964-87

  Unit Trust of India (UTI) established 1963 by an Act of Parliament, was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was separated from the RBI and the Industrial Development Bank of India (IDBI) took charge of the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964.

- ✓ **Second Phase** – 1987-1993 (Entry of Public Sector Funds)

  The year 1987 marked the entry of new public sector mutual funds set up by public sector banks and Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC). The first non-UTI mutual funds to appear were (in order):

  - ✓ SBI Mutual Fund - June 1987
  - ✓ Canbank Mutual Fund - December 1987
  - ✓ Punjab National Bank Mutual Fund - August 1989

- ✓ Indian Bank Mutual Fund - November 1989
- ✓ Bank of India - June 1990
- ✓ Bank of Baroda Mutual Fund - October 1992
- ✓ LIC Mutual Fund - June 1989
- ✓ GIC Mutual Fund - December 1990

✓ **Third Phase** – 1993-2003 (Entry of Private Sector Funds)

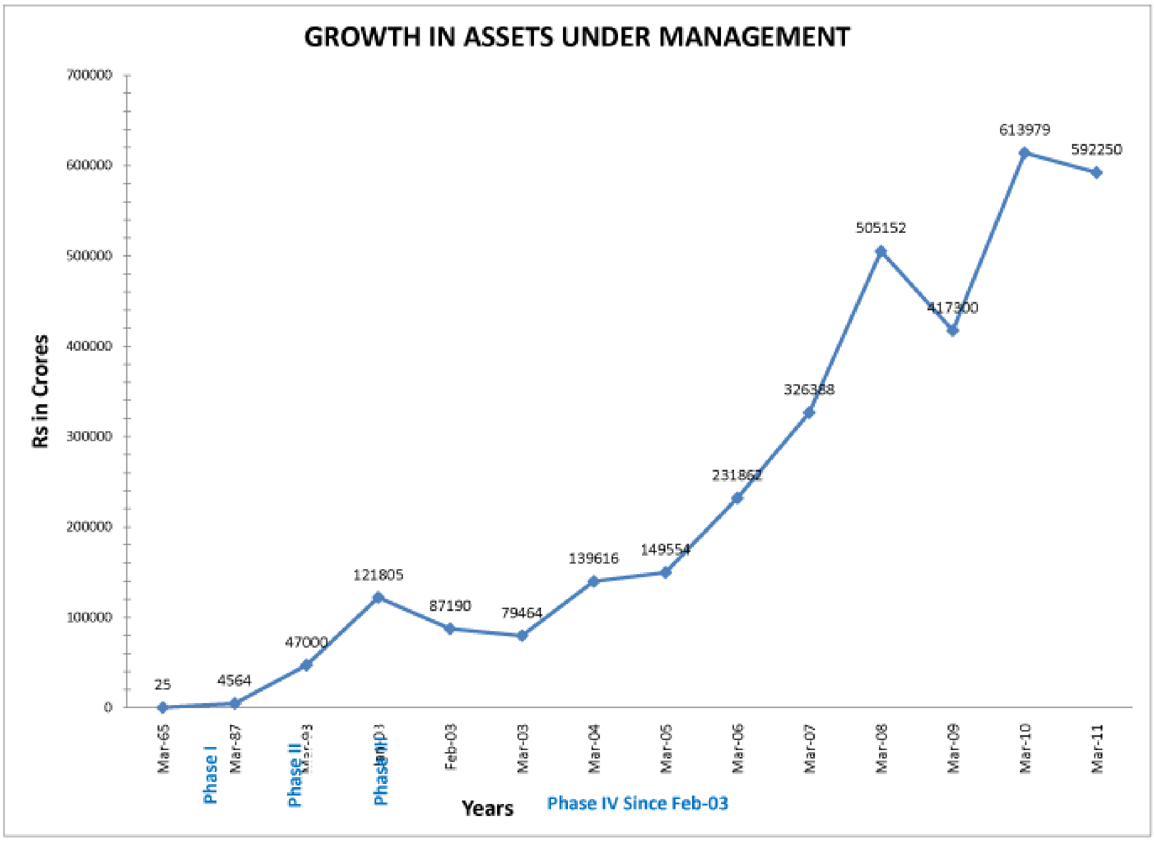
With the entry of private sector funds in 1993 gave the Indian investors a wider choice of fund families. At this time, the first Mutual Fund Regulations also came into being, under which all mutual funds (except UTI) were to be registered and governed. The Kothari Pioneer was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996. The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions.

✓ **Fourth Phase** – February 2003 onwards

In February 2003 UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India, representing broadly, the assets of US 64 scheme, assured return and certain other schemes. The Specified Undertaking of Unit Trust of India, functioning under an administrator and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. The graph indicates the growth of assets over the years.



Note:

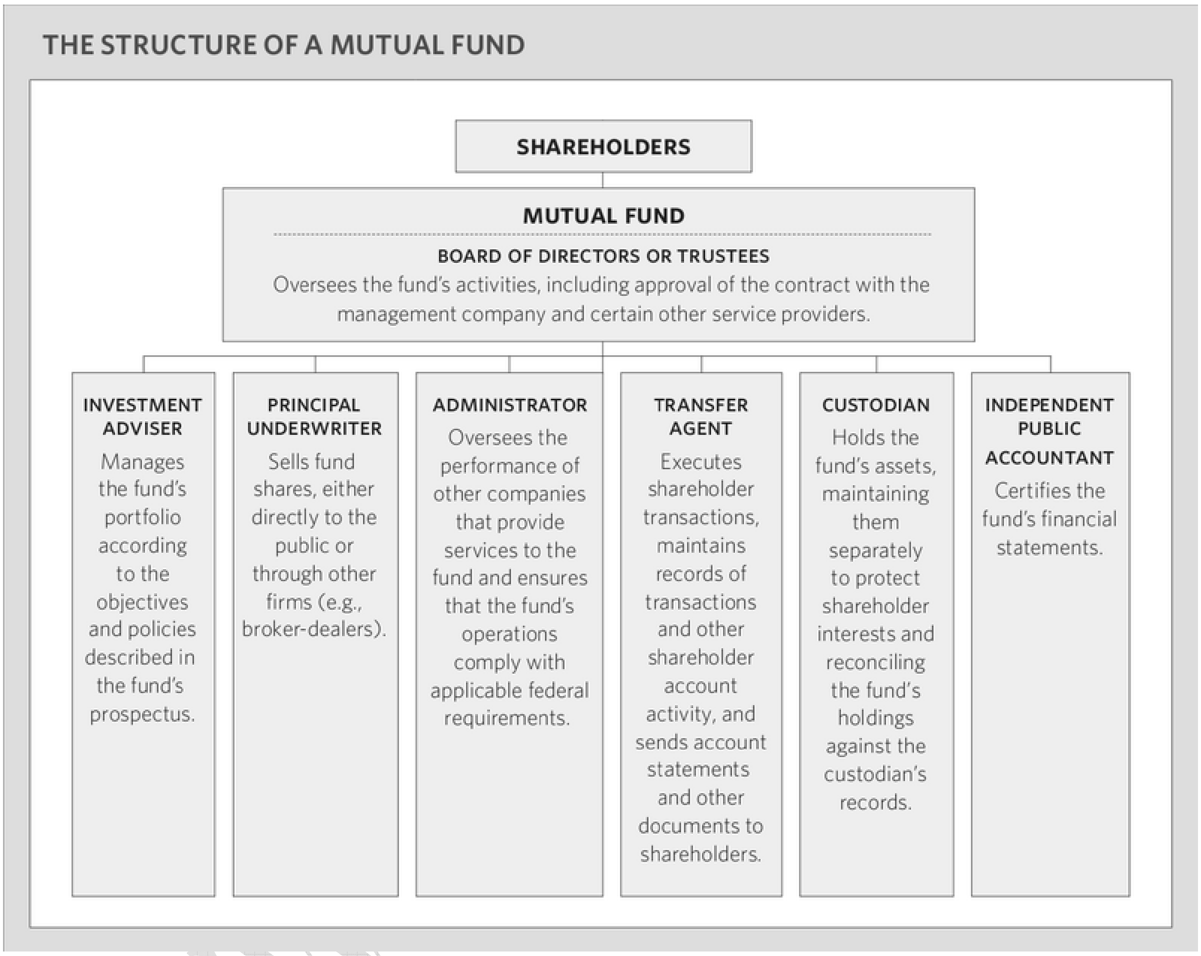
UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. The Assets under management of the Specified Undertaking of the Unit Trust of India has therefore been excluded from the total assets of the industry as a whole from February 2003 onwards.

SEBI formulates policies and regulates the mutual funds to protect the interest of the investors and it notified regulations for the mutual funds in 1993. Thereafter, mutual funds sponsored by private sector entities were allowed to enter the capital market. The regulations were fully revised in 1996 and have been amended thereafter from time to time. SEBI has also issued guidelines to the mutual funds from time to time to protect the interests of investors.

All mutual funds whether public or private including those promoted by foreign entities are governed by the same set of Regulations. There is no distinction in regulatory requirements for these mutual funds and all are subject to monitoring and inspections by SEBI. The risks associated with the schemes launched by the mutual funds sponsored by these entities are of similar type.

1.6 Structure of Mutual Funds

It is imperative for a person to know the structure of a mutual fund. It is important to understand how a mutual fund comes into being, who the important people are, and what their roles are.



Mutual Funds in India follow a 3-tier structure. There is a Sponsor (the First tier), who thinks of starting a mutual fund. The Sponsor approaches the Securities & Exchange Board of India (SEBI), which is the market regulator and also the regulator for mutual funds.

There are restrictions on starting a mutual fund. SEBI enquires whether the person is of integrity, whether he or she has enough experience in the financial sector along with his or her net worth. Once the verification is done, the sponsor creates a Public Trust (the Second tier) as per the Indian Trusts Act, 1882. Trusts have no legal identity in India and cannot enter into contracts, hence the Trustees are the people authorized to act on behalf of the Trust. Contracts are entered into in the name of the Trustees. Once the Trust is created, it is registered with SEBI after which this trust is known as the mutual fund.

The Asset Management Company forms the Third tier. Trustees appoint the Asset Management Company (AMC), to manage investor's money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. The AMC's Board of Directors must have at least 50% of Directors who are independent directors. The AMC has to be approved by SEBI.