Chapter-I

INTRODUCTION

The Indian mutual funds industry has made remarkable strides in the recent past. The Assets under management (AUM) registered during 2014-15 an year-on-year growth of 31.21 per cent with the total AUM as on March 31, 2015 standing at ₹10,82,757 crore (SEBI Annual Report 2014-15: 65). Net resources mobilised during 2014-15 also grew by 92 per cent. Over the decade between 2004-05 and 2014-15, the industry witnessed a six-fold increase in the AUM. As the data furnished by ASSOCHAM shows, the number of investor accounts was 42.8 million by June 2015 (ASSOCHAM & ICRA 2015: 20).

Indeed, since the 1990's, after the mutual fund space was opened up to the private sector, the industry has come a long way. As of late, both the AUM and the profits of the industry have surpassed the 2007 levels (CII & McKinsey 2015: 3). A study of the trend of assets under management (AUM) over the past decade indicates a sharp recovery from the dip that accompanied the global melt-down crisis, with approximately an annual average growth of 20 per cent during the four year period between 2012 and 2015. This implies a regaining of confidence by investors. As of September 2015, the 10-year average return generated by Indian mutual funds across all fund types and asset classes was around 10.2 per cent. Equity-oriented schemes returned during the year 13.8 per cent and debt schemes, 7.9 per cent (ASSOCHAM & ICRA 2015: 7).

As a sequel to these developments, the post liberalization period has witnessed significant regulatory and procedural changes in the Indian mutual funds industry which have changed the way the market-players used to do

business. The important initiatives in the regulatory front included, among others:

i) the *banning of entry load* that was earlier being deducted from the invested amount, and, simultaneously, *the accordance to customers the right to negotiate* and decide commissions directly with distributors;

ii) the *introduction of certification programme* for distributors making thereby mandatory for distributors, agents or any other person engaged in the sale of mutual fund products to have a valid certificate from the National Institute of Securities Markets;

iii) the allowance of option to investors for holding their units under open-ended schemes in *demat account*;

iv) the accordance of permission to fund houses to charge an *additional fee of up to 0.3 per cent* for expenses on the investment flows from small cities and towns;

v) the promotion of *direct investment* by the investors in existing and new schemes by providing a separate plan for direct investments with a lower expense ratio, wherein no commission or brokerage need to be paid by the investor;

vi) the setting apart of at least two basis points on daily net assets within the maximum limit of total expense ratio ('TER') for investor education and awareness initiatives by asset management companies (AMCs);

vii) the periodic notification of additional disclosure requirements pertaining to portfolio disclosures, financial result disclosures, and the like on mutual funds/AMCs; and also,

viii) the issuance of directions to the AMCs for labelling all MF schemes according to the level of risks involved[1].

The restriction of entry load on existing and new mutual fund schemes in August 2009 triggered changes in the mode of functioning of the mutual fund industry. In the aftermath of this regulatory change, the industry went through a period of sluggish growth resulting from the curtailment of incentives for fund houses and distributors. The impact on the commission structure of fund houses and distributors led these intermediaries to restructuring of their business and operating models.

As per the data furnished by Deloitte and Indian Chambers of Commerce in their report titled *Mutual Fund Industry in India: Deloitte Perspective* released in January 2016, a shift in broad investment patterns of individual investors has of late taken place with investors now tending towards seeing investments in Mutual Funds on a 3-4 year horizon (ICC & Deloitte 2016: 3).

1.1 THE PROBLEM & THE RESEARCH QUESTIONS

Despite its possession of a modest growth-record, the overall growth rate of the Indian mutual funds industry when compared with industries in the developed and the emerging market economies of the globe appear somewhat sluggish.

First, the AUM as a per cent of GDP in India currently stands at around 5 to 6 per cent. This is significantly lower than the levels in many of the emerging economies. For instance, the AUM/GDP ratio is around 40 per cent in Brazil, while the same is around 33 per cent in South Africa (ICC & KPMG 2014: 2).

Secondly, the mutual funds industry's penetration levels in India still appear miniscule when compared with the attained levels in

[1]Circular No. CIR/IMD/DF/5/2013 dated March 18, 2013

the developed economies of the globe. As already mentioned, the top fifteen metros and big cities in India together have with them the lion's share of the total AUM in India. An idea of the uneven distribution of AUMs may be obtained from the fact that the top five metro cities together contribute around 72 per cent of the total AUM at present (CII & McKinsey 2015: 18).

Thirdly, the investors' contributions towards mutual funds have persistently remained skewed towards the investments coming from the corporate sector; the investments by the retail investors have lagged far behind (ASSOCHAM & PWC 2010: 5).

Fourthly, one of the reasons why mutual funds have failed to build confidence among the investors is that most often, the risk attached to the product is "underwraps". Thus, the long term benefit of remaining invested in these funds over a long term horizon is lost on the investor. The result is that, a product designed for a small investor fails to foster a market for itself. Implementing disclosure practices is likely to lead to increased transparency, which in turn may result in increased confidence of the investor (ASSOCHAM & PWC 2010: 6).

In today's dynamic market-environment, the promotion of financial literacy is seen as a critical imperative for optimising growth of the mutual funds industry. Although, the investors in metros are more familiar with mutual funds as a profitable channel of investment, people in smaller towns and cities are not in a position to assess the pros and cons of various MF schemes and of the risks attached thereto, and therefore disclosures need to be made very clear and easily accessible by all present and prospective investors. Mapping the requirements of investors in the form of a hierarchy of needs (akin to Maslow's Model) (CII &

PWC 2010: 14) shows that the new age investor demands higher rate of returns, more transparency and the freedom to choose from a wide range of product alternatives. Hence, while selling to "first time" customers, it is of utmost importance that all the *terms and conditions* attached are plainly laid out before them. Compliance to disclosure requirements should be assigned the due priority by all asset management companies for institutionalizing greater transparency in the system. Information should be readily available and communicated effectively to investors enabling them to take informed decisions.

The above facts certainly are indicative of the current status of less-than optimal actualisation of growth-potential of the industry in this country. Indeed an engaging issue at the moment is seen in the industry's noticed inability or indifference in coming closer to the investors, particularly, in the matter of maintenance by fund houses of transparency of operations and in their initiatives in the direction of promoting an unhindered framework/ channel of information-flow.

Knowingly, in an ideal state of affairs, it is normal that investors would base their investment-decisions on informed choices. To put it differently, when things are normal and ideal, the volume of investment that can be garnered by Fund houses in the industry would crucially depend not only on the firms' specific records of performance or of profits, but also on their ability to fulfil the information-needs of investors *via* their maintenance of timely and fair disclosure practices. The question that arises in the given context is how far the Indian Mutual Funds houses could ensure so far fair and timely disclosure practices? As within the framework of a regulatory environment, disclosures are governed by statutory disclosure requirements, one also needs to know how the firms in Indian mutual funds industry have responded to the statutory disclosure requirements. Further, as information routinely released via

disclosures promote both investors' awareness and investors' confidence, and as the major players in the industry (i.e., the fund houses with superior performance and larger market-shares) are expected to exhibit better responsiveness in relation to others in the matter of disclosure, the question whether performance had any visible impact on disclosures and *vice-versa* needs also to be examined.

1.2 OBJECTIVES OF THE STUDY

In the context of the raised research questions, the study takes the following four as its specific objectives:

i) to assess the trend of growth of Mutual Funds industry in India during the period from 2004-05 to 2014-15,

ii) to examine the performance of the fund houses in terms of select parameters;

iii) to delineate the prevalent regulatory framework with regard to the mandatory disclosure by fund houses and to examine the disclosure practices of these houses; and finally,

iv) to find whether any association exists between the disclosure practices and the performance of Fund Houses in India.

1.3 SCOPE OF THE STUDY

As is evident from its stated objectives, the present enquiry confines itself to examination of the trend of growth of the mutual funds industry in India and to assessing the performance and disclosure practices of fund houses operating in the industry.

All the fund houses operating in India during the study-period (2004-05 to 2014-15) together constituted the broad universe of the present enquiry.

Temporally speaking, the ten year period from 2004-05 to 2014-15 is taken for the purpose of the enquiry as the study period.

The choice of 2004-05 as the base year was based upon the following considerations:

The 1990s constituted together a decade of liberalization of the economy. Reforms in any country are always a function of the condition of financial markets at the time of the reform (Government of India 2015: 41). Till the early 1990s the prime initiatives and concern in India revolved around the channelization of surplus resources towards the formal financial sector. The role of technology till then was limited and hardly any priority was being assigned to maintenance of customer relationship or good service standard. Risk management procedures and prudential norms were weak, affecting asset portfolio and profitability. There have been significant reforms in the regulation of the securities market since1992 in conjunction with the overall economic and financial reforms. To bring greater efficiency, order and transparency, the process of reform of the capital market was initiated in 1992 along the lines recommended by the Narasimham Committee. This led to the introduction of many significant practices including the accordance of statutory power in 1992 to the Securities and Exchange Board of India (SEBI). SEBI was later made the regulator of capital market by a resolution of the Government of India in 1998. Other initiatives like the opening of the capital market to the foreign investors (1993), the formation of the National Stock Exchange of India (1994), the introduction of electronic trading system (1995), the opening of the National Securities Depository Limited (1996) for business, the commencement of futures trading (1999), the shortening of settlement cycle from T+3 to T+2 (2003) followed the suit. During the 1990, admittedly, the functioning and the stability of the capital market remained somewhat subdued mainly because of occurrence of two large scams, namely, the Harshad Mehta Scam and the Ketan Mehta scam. These scams of course paved the way for appointment of the Kumarmangalam Birla Committee in 1999 and

thereafter for inclusion of Clause 49 (in 2000) in the listing agreement based on the recommendations contained in the said committee Report. Once again in the year 2003, SEBI revised the Clause 49 of the listing agreement based on the recommendations of the second committee on Corporate Governance formed in late 2002 under the Chairmanship of N. R. Narayana Murthy (ASSOCAHM & PWC 2010: 30)

As compared to the observed volatility of the 1990s, the capital market started settling down to normalcy during the decade following 2000. It is from the year 2004-05, Sensex, the barometer index of the Indian capital market, started its growth rally and attained newer heights. It crossed the historic 30,000 mark during March 2015 from a less than 5000 level recorded during May, 2004. Except some occasional turbulence experienced during the emergence of global financial crisis of 2007-08, overall the market maintained its growth momentum consistently during this period. As a result of this the year 2004-05 was considered as the base year for the purpose of the study.

The terminal year for the purpose of the enquiry (2014-15) was prompted by considerations linked to the availability of latest data.

1.4 METHODOLOGY

The study adopts for itself a descriptive framework and bases the enquiry mainly on secondary data.

For accomplishing the objectives of enquiry, a four-tier framework of investigation is adopted:

At the first stage, by taking the overall growth-trend of the industry as the backdrop, the performance of the fund houses is examined. For measuring performance, (i) the net accretion to Average Assets under Management (AAUM), and (ii) the net resource mobilization are taken as the indicators of the aggregate performance of the mutual funds.

In the second stage, the performance ranking thus obtained for the selected fund houses are corroborated by evaluating the selected schemes of the top and bottom ranked fund house with the help of standard performance evaluation models.

In the third stage, the disclosure practices of firms are assessed. The responsiveness of the fund houses towards statutory disclosure requirements is weighed by using ten selected disclosure areas. The disclosure levels of the fund houses are ascertained for each one of the ten disclosure areas separately and scores in terms of percentage were assigned to every single fund house based on their noticed disclosure levels.

Finally, attempt is made to seek answer to the question - "whether a higher performance-ranking of a fund house instantly also means for it a higher rank in terms of responsiveness to statutory disclosure-requirements and *vice-versa*". For finding the answer, the possibility of existence of association between the performance of the selected fund houses and their observed disclosure practices is specifically examined. Cramer's V test is used for ascertaining the possibility of existence of association between the stated two sets of variables.

Although the whole of the mutual funds industry initially constituted the universe of enquiry, eight firms from within the industry were purposively selected for intensive investigation of performance and disclosure practices. These eight fund houses together accounted for 42.08 per cent of the Average Assets under Management (AAUM), and 45.25 per cent of the net resources mobilized in the industry and, hence, logically may be taken as representative population for the universe under reference.

1.5 TERMS USED

(i) Mutual Fund Defined

Securities and Exchange Board of India defines mutual fund as "a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets" [SEBI (Mutual Funds) Regulations, 1996: 8].

According to *U.S. Securities and Exchange Commission* "A mutual fund is an SEC-registered open-end investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments" (SEC Mutual Funds and ETFs: 4).

Association of Mutual Funds in India has given the simplest definition of mutual funds stating "the money pooled in by a large number of investors is what makes up a Mutual Fund".

As per the definition of *Investment Company Institute, USA*, "a mutual fund is financial service organisation that receives money from shareholders, invests it, earns returns on it, attempts to make it grow to pay the shareholders cash on demand for the current value of his investment".

Indian Institute of Banking and Finance defines mutual fund as "A mutual fund is a type of financial intermediary that pools the funds of investors who seek the same general investment objective & invests them in number of different types of financial claims (e.g. equity shares, bonds, money market instruments)".

(ii) Associate

It includes a person, -

(a) who directly or indirectly, by himself, or in combination with relatives, exercises control over the asset management company or the trustee, as the case may be, or

(b) in respect of whom the asset management company or the trustee, directly or indirectly, by itself, or in combination with other persons exercises a control, or

(c) whose director, officer or employee is a director, officer or employee of the asset management company; [SEBI (Mutual Funds) Regulations, 1996: 6-7].

(iii) Asset Management Company (AMC)

Asset Management Company, also known as a Fund House, means a company formed and registered under the Companies Act, 1956 (1 of 1956) and approved as such by the Board under sub-regulation(2) of regulation 21. [SEBI (Mutual Funds) Regulations, 1996: 7].

(iv) Broker

Broker means a stock broker as defined in Securities and Exchange Board of India (Stock Brokers and Sub-brokers) Rules, 1992 [SEBI (Mutual Funds) Regulations, 1996: 7].

(v) Custodian

Custodian means a person who has been granted a certificate of registration to carry on the business of custodian of securities under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996 [SEBI (Mutual Funds) Regulations, 1996: 7].

(vi) Depository

A person who has been granted a certificate of registration to carry on the business of custodian of securities under the Securities and Exchange Board of India (Custodian of Securities) Regulations, 1996 [SEBI (Mutual Funds) Regulations, 1996: 7].

(vii) Money Market Instruments

Money market instruments includes commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time [SEBI (Mutual Funds) Regulations, 1996: 8].

(viii) Offer Document

"offer document" means any document by which a mutual fund invites public for subscription of units of a scheme [SEBI (Mutual Funds) Regulations, 1996: 8].

(ix) Scheme

Scheme means a scheme of a mutual fund launched under Chapter V of SEBI (Mutual Funds) Regulations, 1996 [SEBI (Mutual Funds) Regulations, 1996: 8].

(x) Schedule

Schedule means any of the schedules annexed to SEBI (Mutual Funds) Regulations, 1996 [SEBI (Mutual Funds) Regulations, 1996: 8].

(xi) Sponsor

Any person who, acting alone or in combination with another body corporate, establishes a mutual fund [SEBI (Mutual Funds) Regulations, 1996: 8].

(xii) Trustee

Trustees mean the Board of Trustees or the Trustee Company who hold the property of the Mutual Fund in trust for the benefit of the unit holders [SEBI (Mutual Funds) Regulations, 1996: 9].

(xiii) Unit

Unit means the interest of the unit holders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme [SEBI (Mutual Funds) Regulations, 1996: 9].

(xiv) Unit holder

Unit holder means a person holding unit in a scheme of a mutual fund [SEBI (Mutual Funds) Regulations, 1996: 9].

1.6 CHAPTER-SCHEME

The broad framework of the thesis is as follows:

Chapter I: this introductory chapter of the thesis specifies the research problems and the objectives, and delimits the scope and methodology of the study.

Chapter II: describes the trend of growth of Mutual Funds industry in India during the period from 2004-05 to 2014-15.

Chapter III: throws light on the performance of the selected fund houses on the basis of standard performance evaluation techniques identified through the review of earlier studies.

Chapter IV: identifies the regulatory framework prevailing in India with regard to the statutory disclosure requirements of the fund houses and examines the response of the fund houses in terms of their disclosure levels.

Chapter V: examines the association between the performance of the fund houses and their disclosure levels on the areas mandated by the Regulator, SEBI.

Chapter VI: presents a summary of the findings of the study.

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