

# Mutual Funds

## Meaning

A Mutual Fund is a collective investment vehicle formed with the specific objective of raising money from a large number of individuals and investing it according to a pre-specified objective, with the benefits accrued to be shared among the investors on a pro-rata basis in proportion to their investment.

According to Encyclopedia Americana, “Mutual funds are open end investment companies that invest shareholders’ money in portfolio or securities. They are open ended in that they normally offer new shares to the public on a continuing basis and promise to redeem outstanding shares on any business day.”

According to Securities and Exchange Board of India Regulations, 1996 a mutual fund means “a fund established in the form of trust to raise money 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”.

## Features of Mutual Funds:

### 1. Portfolio Diversification/Risk Diversification

Most Mutual Funds invest in 50 to 100 different investments based on market capitalisation, sectors and many other demographics. \*Only on a rare occasion do all stocks decline at the same time and in the same proportion. Hence, Mutual Funds offer a diversified investment portfolio even with a small amount of investment that would otherwise require big capital.

### 2. Professional Management

Mutual Fund schemes are managed by qualified experienced professionals who work towards the fund's defined objective. These financial experts are accompanied by a specialized investment research team. The experts and their teams diligently and judiciously study companies, their products and performance. After thorough analysis, the best investment option most aptly suited to achieve the scheme's objective is chosen. This continuous process adds value to your investment and helps obtain higher returns.

### 3. Affordability

A mutual fund invests generally buy and sell various asset classes in large volumes allowing investors to benefit from lower trading costs. Investors can get exposure to such portfolios with an modest amount in mutual funds through a Systematic Investment Plan. Such portfolio would otherwise be extremely expensive to purchase and maintain for an investor investing directly in stock market.

#### **4. Transparency**

Mutual Funds are the most transparent form of investment. Investors receive detailed information and timely updates about the nature of investments made, fund manager's investment strategy behind the investments, the exact amount invested in each type of security, etc.

#### **5. Liquidity**

With open ended funds, investors can redeem (encash) all or part of their investments at prevailing net asset value, at any point of time. Mutual Funds are more liquid than most investments in shares, deposits, and bonds. In addition, a standardised process enables quick and efficient redemption allowing investors to get cash in hand as soon as possible.

#### **6. Regulations**

All Mutual Funds are required to register with Securities Exchange Board of India (SEBI). With investor interest at the helm, SEBI has laid down strict regulations to safeguard investors against possible frauds. It is even mandatory for Mutual Fund distributors to register with Association of Mutual Funds in India (AMFI) and abide the norms laid by the Securities and Exchange Board of India (SEBI) and AMFI for the distributors.

#### **7. Choice of Investment**

Mutual Funds are the only product category that caters to every one's needs. You will always find a mutual fund that matches your time horizon – long, medium, or short; and your risk-taking ability – low, medium, high.

### **Parties to Mutual fund**

The following are the various entities that are involve in the organisational structure of mutual fund:

- 1. Investors:** Every investor, given his/her financial position and personal disposition, has a certain inclination to take risk. The hypothesis is that by taking an incremental risk, it would be possible for the investor to earn an incremental return. Mutual fund is a solution for investors who lack the time, the inclination or the skills to actively manage their investment risk in individual securities. They delegate this role to the mutual fund, while retaining the right and the obligation to monitor their investments in the scheme.
- 2. Sponsors:** Sponsor is the company, which sets up the Mutual Fund as per the provisions laid down by the Securities and Exchange Board of India (SEBI). SEBI

mainly fixes the criteria of sponsors based on sufficient experience, net worth, and past track record.

- 3. Asset Management Company (AMC):** The AMC manages the funds of the various schemes and employs a large number of professionals for investment, research and agent servicing. The AMC also comes out with new schemes periodically. It plays a key role in the running of mutual fund and operates under the supervision and guidance of the trustees. An AMC's income comes from the management fees, it charges for the schemes it manages. The management fees, is calculated as a percentage of net assets managed.

SEBI has issued the following guidelines for the formation of AMCs:

- a) An AMC should be headed by an independent non-interested and non executive chairman.
- b) The managing director and other executive staff should be full-time employees of AMC.
- c) Fifty per cent of the board of trustees of AMC should be outside directors who are not in any way connected with the bank.
- d) The board of directors shall not be entitled to any remuneration other than the sitting fees.
- e) The AMCs will not be permitted to conduct other activities such as merchant banking or issue management.

**4. Trustees:** Trustees are an important link in the working of any mutual fund. They are responsible for ensuring that investors' interests in a scheme are taken care of properly. They do this by a constant monitoring of the operations of the various schemes. In return for their services, they are paid trustee fees, which are normally charged to the scheme.

- 5. Distributors:** Distributors earn a commission for bringing investors into the schemes of a mutual fund. This commission is an expense for the scheme. Depending on the financial and physical resources at their disposal, the distributors could be:

- a) Tier 1 distributors who have their own or franchised network reaching out to investors all across the country; or
- b) Tier 2 distributors who are generally regional players with some reach within their region; or
- c) Tier 3 distributors who are small and marginal players with limited reach.

The distributors earn a commission from the AMC.

- 6. Registrars:** An investor's holding in mutual fund schemes is typically tracked by the schemes' Registrar and Transfer Agent (R & T). Some AMCs prefer to handle this role on their own instead of appointing R & T. The Registrar or the AMC as the case may be maintains an account of the investors' investments and disinvestments from the schemes. Requests to invest more money into a scheme or to redeem money against existing investments in a scheme are processed by the R & T.

- 7. Custodian/ Depository:** The custodian maintains custody of the securities in which the scheme invests. This ensures an ongoing independent record of the investments of the scheme. The custodian also follows up on various corporate actions, such as rights, bonus and dividends declared by investee companies. At present, when the securities are being dematerialized, the role of the depository for such independent record of investments is growing.