Small Investors Orientation for Mutual Funds

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1. Background

1.1 Though the concept of investment in units has been prevalent in India for over four decades, with Unit Trust of India itself having an investor base of more than 2.8 crores investors at a point in time, a survey on saving habits in India conducted by ADB in 2004, showed that the confidence levels of households regarding mutual funds was low. Most households were uncertain about the role and function of the industry. While investment avenues like postal savings, bank deposits, insurance, provident funds and even direct purchase of securities were well understood, the finding pointed out that in the risk - return matrix, mutual funds had a fuzzy placement. The investors who wanted a safe investment were not sure about taking the risk, while, the investors who wanted to take risks in investments preferred to trade in securities directly.

1.2 As of March 2007, the Indian mutual fund industry has more than doubled to the size of Rs. 3.20 Lakh crores plus, from an AUM of Rs. 1.34 Lakh crores in March 2004. The number of players have increased substantially with many more lined up to enter the Indian markets. This data shows that the mutual funds investments have grown, but what this data does not show is the growth in number of retail investors. Though the correct number of retail investors in the mutual funds is not available, a number of nearly 3 crore investor account is mentioned as a proxy. This, however may not be correct as a lot of investors have their investments across fund houses and the numbers therefore are not consolidated. Even, when the investor invests in different schemes of the same fund house, without mentioning the folio number a new investor account is created. The correct number of investors is probably less than 1 crore.

2. Global Scenario

2.1 The table below provides net assets of selected countries across the world.

Table 1

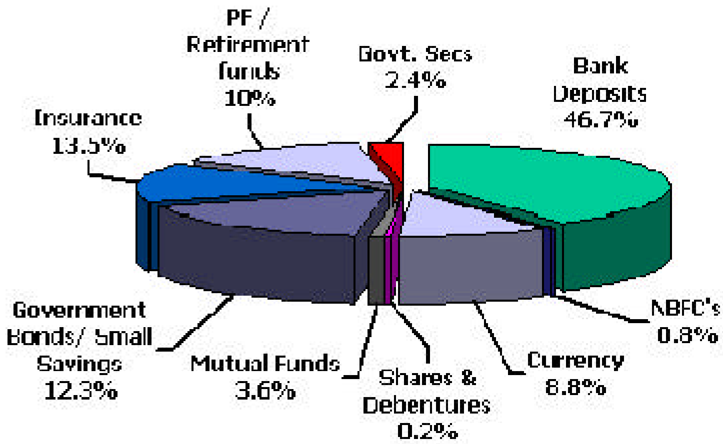
World wide total net assets of mutual funds (Millions of US $, end of year)			
Country	**1998**	**2001**	**2006**
Chile	2910	5090	17700
Mexico	NA	31723	62614
United States	5525209	6974913	10413617
France	626154	713378	1769258
Luxembourg	508441	758720	2188278
Australia	295403	334016	864254
India	8685	15284	58219
Korea	165028	119439	251930
United Kingdom	277551	316702	786501

Source: ICI Fact Book 2007

2.2 USA has the largest size in mutual fund industry in the world, followed by Luxembourg. In the USA, 48% of the households owned mutual funds in 2004 against 6% in the year 1980. In USA, individuals own 90% of the Industry total assets. Business, State corporations or local bodies own the balance 10%. An important aspect of US mutual fund industry is that 60% of the funds in the industry are due to retirement plans, which have seen more than twenty-fold increase since 1990.

2.3 In UK, 80% of the assets are invested on behalf of institutional investors, the retail accounting for less than 20%. Within the institutional market, corporate pension funds and insurance companies account for 75% of total business. Even in developing countries, the trend is towards retirement assets forming greater part of the MF industry. Mix of distribution channels in different countries have been guided by the regulatory environment. The trend towards an increased use of new technology in selling MF products is being noticed across countries.

3. <u>Where are the Household investments parked</u>



Source: RBI Annual Report, 2005-06

3.1 A break-up of the investments shows that less than 4% of the savings is in mutual funds. What is further striking is that more than 56% of the Assets under Management (AUM) is in Liquid and Debt, which comes typically from non-retail investors and that too primarily for tax arbitrage reasons.

Table 2

Industry Data (Assets under Management) (in Rs. crores)			
Industry AUM classification			
Year ending March	**Liquid & Debt**	**Total**	**Liquid & Debt Assets as a % of the total Assets**
31-3-2003	47,778	69,725	68.52%
31-3-2004	98,654	138,958	71.00%
31-3-2005	96,197	149,842	64.20%
31-3-2006	115,307	231,624	49.78%
31-3-2007	184,623	326,612	56.53%

Source: AMFI, mutualfundindiaexplorer

4. Why are the small investors missing from Mutual funds?

4.1 Here is an industry that is transparent, efficient, well run, carries risk in the form of market risk but little risk of fraud — not a single mutual fund has run away with the investors' money in the 14 years since the private sector was allowed into the fund business. NAVs may have gone up and down, but that is as a result of market conditions, not because of manipulation. The Securities and Exchange Board of India (SEBI) Mutual Funds Regulations are well laid and lead to a fairly well regulated industry. Money transfer is streamlined and happens within three days, through ECS into bank accounts and investments are made only as per the SEBI regulations and only in investment grade companies.

4.2 Despite being such a well-regulated industry the participation of the retail investors is not as per expectations. This is because of the following issues.

4.2.1 Focus on Corporates:

In the rush to end up on a higher pedestal for month end Assets under Management, many fund houses focus on generating investments from Corporates. This also means lesser efforts and lesser transaction cost for the fund house. Before the regulator, Securities and Exchange Board of India (SEBI) came in with the 20:25 regulation *(wherein every scheme has to have a minimum of 20 investors and that no single investors can hold more than 25% in that scheme),* many of the liquid schemes had one or a few investors. What happened as a result, was if a single big investor withdrew his money, the returns of the other investors would suffer considerably.

4.2.2 Minimum Investment Amount:

Mutual funds have been designed to serve small investors. But if an investor goes to a fund house with an investment of Rs. 1000, the response that he gets from the fund house is very cold. The given reason behind this is that the fees received by the fund house on Rs. 1000 is much less than the expenditure that the fund house will incur on servicing this investor. Therefore, some fund houses set their lowest investment amount at higher levels and the small investor is not able to invest in a scheme that he wants. But what the fund house does not understand is that the retail investor is likely to remain in the fund for a longer period.

4.2.3 Entry Loads and Exit Loads:

Fund houses, have created an entry barrier for the small investor by charging him an Entry Load or Exit Load and sometimes both for his investments, which in turn diminishes his returns and the investor feels cheated. Also many of the fund houses discriminate in the load structure for the small i.e. retail investor and the big investor by charging lower loads or no loads to the big investors. Also loads are charged on passively managed Index Funds *(which mimic the Index and give similar returns to the index),* which are a better investment avenue for the small investor due to its lower risk and lower cost structure.

4.2.4 Most bond funds have differential exit loads for investments of different sizes, scaling down the exit load as the size of the investment increases. Quite a few fund houses scale down, or even waive, exit loads for larger redemptions. One can argue that a larger transaction size reduces paperwork and related transaction costs. Therefore, by scaling down loads for larger investors, fund houses may only be passing on the cost savings. True, a frequently changing corpus size can prevent the fund manager from taking a long-term view of his asset allocation pattern and sticking with it consistently. But, if exit loads are to serve this purpose, larger redemptions should ideally be charged a higher exit load than smaller redemptions. But the crux of the issue seems to be that while larger investors pay greater attention to such factors as entry and exit loads while investing in a mutual fund and therefore their selection of the fund house is dependent on the load structures charged by the fund houses.

4.2.5 Distribution Channels:

Mutual fund products are sold through the distributor network — individuals, finance companies, large distribution houses and banks (Public and Private Sector). Large number of retail investors, have started distrusting the distributor, who, the investor is convinced, is looking after his own interest. This investor behaviour, is translating into low retail investor participation in mutual funds. Some Distributors also push mutual funds New Fund Offers (NFO) that earn them much higher commissions, as compared to existing schemes that earn them a much lower fee. Also, unlike the insurance industry, there is no regulation of the mutual fund distributors. The system of tied agents prevalent in the insurance industry is also not enforced here.

4.2.6 Focus on Large Cities:

Most of the fund houses have their sales office locations in the top 10 cities and a token presence in other cities. This is because the Assets under Management of most of the fund houses comes from the top 10 cities. Data from the Registrars show that more than 80% of the industry non - liquid AUM comes from the top 10 cities and that more than 90% comes from the top 20 cities. Also due to the tight promotion budgets, fund houses find it easier to spend the same in Metros where the returns are seen more instantaneously. This can be compared with the fact that the number of cities where NSE had broker terminals has increased from 208 in 2001 – 02 to 1148 in 2006 – 07. This is a clear indication of the awareness about the capital market even in smaller cities and the inability of the mutual fund industry to tap the same.

4.2.7 Lack of Investor Education and Financial Literacy:

In India despite the presence of multitudes of newspapers and television channels, investor awareness is an area that leaves a lot to desire especially in the smaller towns. Even today, individual investors do not understand and appreciate the risks that they take in investing. It is often seen that individuals are not comfortable taking investment decisions and therefore tend to postpone them. They also do not have the benefit of comparing the various investment products so that they can choose the best according to their risk profile. Investor education is important because it helps investors understand the importance of financial planning; allowing them to recognise the possible changes in their financial needs and identify future risks related to their business activities. But none of the information mediums have taken an active interest in investor education for mutual funds.

4.2.8 Multiplicity of Investment Products:

On the last count, the Indian Mutual Fund industry had more than 150 Equity Funds, and numerous more Debt Funds from 33 Fund houses. Also complexities are built into these products like hedging, which make it very difficult for a small investor to understand the different kinds of products. This gives scope for mis-selling and many times investors are duped into investing in products, which may not be suited for the investor.

5 Recent developments

5.1 Popularity of SIPs

One of the welcome developments for the mutual funds is the increasing popularity of Systematic Investment Plans (SIP). An industry estimate indicates that more than 50 thousand new SIPs are being opened every month. SIPs are the best route of investment for an investor as it removes the need for timing the market, as also provides a route for the small investor to invest small amounts on a regular basis thus inculcating a habit of saving.

5.2 Micro SIPs

UTI AMC has pioneered the concept of Micro SIP by offering investors an option to invest as less as Rs. 50 per month in its Retirement Benefit Pension Fund. Now other fund houses are adopting this model and offering SIPs with minimum investment of Rs. 100. This augurs well for the small investors, as now they can sample the benefit of investing through mutual funds by investing small amounts.

5.3 ECS and Auto-debit

Today all the fund houses give an option of direct credit through ECS and auto-debit facilities. This has increased the ease of investing in mutual funds for investors, and has also reduced the chances of loss of pilferage and losses. Also due to the ECS facility the investor receives his redemption amount in 3 days.

5.4 Investor Services by Registrars

The Registrar and Transfer Agents have set up their Service Centre mostly in small cities where the fund houses themselves do not have their own offices. This increases the ease of transaction for the investor as well allows the investor to sort out his investment queries. The visual presence of the Service Centres also increases the awareness of mutual funds in these centers.

5.5 Selling of mutual funds by Public Sector Banks and Post offices

Public Sector Banks as well as Post Offices serve mainly to the small retail investor. Also they are unparalleled in their reach to the remote corners of the country. Mutual funds can use this network to reach to investors at locations where the fund house would not have presence.

6 The Way forward

6.1 Retirement Savings

6.1.1 In the USA, post 1990, the mutual fund industry received a major boost, due to the inflow of retirement savings into the mutual fund industry, primarily through the 401 (K) and Individual Retirement Arrangements (IRA).

Unfortunately, in India, the existing Government mandated Provident Funds like Employees' Provident Fund Organisation (EPFO), etc. do not invest in Mutual funds even though the investment guidelines issued by the Ministry of Finance permit the same. There are more than 400 million workers in the country. EPFO has more than 40 million accounts. With rising longevity, changing demographic profile and breakdown of the joint family system, saving for old age income security has become an imperative. It is therefore safe to assume that over a period of time, the pressure of providing higher returns to these employees would impel these funds to move towards mutual funds.

6.1.2 Workers in the unorganised sector as also the voluntary retirement planners also hold promise for the industry. Already the Pension Funds Regulatory and Development Authority (PFRDA) have called for Expression of Interest for managing the New Pension System (NPS) assets, and this start should lead gradually to management of the entire pension funds by the Asset Management Companies. It is thus possible for the industry to provide avenues for retirement planning - both for tax-payers and non-taxpayers.

6.1.3 The Micro Pension scheme of UTI Mutual Fund for the retirement saving of individuals is an example of how workers can be motivated to start saving for their old age. By investing small amounts every month, these workers have started building up a corpus for themselves for their old age. The scheme, which has a balanced portfolio with a portion invested in equity, has given a return much higher than the fixed income instruments. While inaugurating the Scheme, the Union Finance Minister, Shri P. Chidambaram termed it as "the beginning of a pension revolution in the country". More number of such schemes by the entire industry are required.

6.2 Technology

6.2.1 The demographic profile of investors has undergone a major change. Due to the booming economy and the ITES sector, professionals in their twenties have disposable income, which is being invested. This trend is seen not only in the metros but also in smaller towns. However, unlike their parents, convenience in transactions is taken as granted by these investors. Technology will play a large role in reaching out to investors in places where physical presence by a mutual fund is not feasible. Already some fund houses have started offering online investments through Internet. Providing information as well as transactions (monetary and non-monetary) through the Internet will prove to be a low cost model for the fund houses.

6.2.2 A look at the NSE data shows that the number of broking terminals increased by 48% in 2005 – 06 and by 32% in 2006 – 07. Against approximately 12,000 terminals in 2001 – 02, the number now exceeds 55,000 across 1148 cities and towns. This is a sure way forward for the mutual fund industry to tap small investors.

6.3 Financial Planning Movement

6.3.1 In view of the diffused understanding about mutual funds, a programme to encourage an active financial planning movement in the country is urgently required. The industry will have to take direct measures to support the financial planning movement. Qualified financial planners having no direct linkage to a manufacturer in the industry are the key to sustained growth of entire financial sector industry. The financial advisors would charge a fee for providing the value-add services in evaluating client needs and then suggesting products, like doctors. The pure distributors will charge a disclosed flat fee and simply sell schemes, like chemists. The informed customer can go to the chemist, the uninformed one can take the help of the doctor.

6.3.2 Mutual fund industry needs to create a fund like USO (Universal Services Obligation) Fund, which exists in the Telecom sector, to fund the education and training requirements. The investor education programme should focus on simple messages about product differentiators, risk-return spectrum and information about cost and fees. The BSE and NSE should be roped in to organise training programmes through their training Institutes. The smaller exchanges can be brought in to carry a detailed scientific investor awareness programmes for small investors at panchayat level under SEBI. The proposed 'National Institute of Securities Markets' of SEBI can be created to groom the investment planners and advisers. Ideally, Government should create a fund and a task force to spread investor education. Besides the Government, the financial sector industry should also contribute to this fund and SEBI can be made the nodal agency for running this movement.

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