Indian Mutual Fund Industry – Paving the Path for Next Big Leap

Navneet Munot
Chief Investment Officer
SBI Funds Management Pvt.Ltd.

The Indian mutual fund industry finds itself in a landscape that has undergone rapid changes over the last few years. From FY2003-2010, the Industry saw a high growth phase with growth in assets under management (AUM) averaging more than 33% a year. Since then, partly due to macro-economic factors linked to slow growth and high inflation and partly due to industry specific issues, growth in the sector has come off sharply. Growth in AUM from FY2010 to FY2014 has slipped considerably to less than 8%. One of the primary challenges faced by the mutual fund industry is the lack of healthy participation from a large part of the country. A striking statistic is that India has 703 million savings bank accounts but just 43 million mutual fund folios; even assuming one individual has more than one bank account or folio this leaves large ground to be covered. Looking at penetration in some sectors like telecom (933 million mobile phone connections) and 2 wheelers (~100 million registered 2 wheelers), there is clearly a large untapped potential for increasing the mutual fund investor base.

The significantly under-penetrated market in India clearly showcases huge opportunity for mutual fund industry players. However, there are several roadblocks that currently prevent the Industry from tapping these opportunities to their optimum potential. These issues, if tackled properly, can lead to a significant increase in household engagement with the mutual fund sector.

Awareness

One of the major reasons behind the under-penetration of mutual funds is the lack of understanding about mutual funds. Investors are still not aware of the several advantages offered by mutual funds: low cost investment vehicle, better risk-return ratio and tax advantages over traditional investments such as bank fixed deposits. Most Indian households tend to be extremely risk averse and wary where they invest their hard earned savings. As a result, they are conservative with their savings and tend to invest in “safe” assets. Indians still feel that gold and real estate are a less risky alternative as compared to investment in mutual funds. A culture change led by a concerted awareness campaign is needed to get people more comfortable investing in capital markets and mutual funds in particular.

Investors often state excessive paperwork as another roadblock to investing in mutual funds. Certain steps could be taken by the capital market regulator with regard to easing of Know Your Customer (KYC) norms in order to make it more convenient for individuals to access mutual funds. For example, individuals having bank accounts would already have fulfilled KYC requirements for the same. Perhaps, we could explore whether investors in mutual funds coming through KYC compliant bank accounts could be exempted from separate KYC requirements for mutual funds. This could encourage more investors to invest in mutual funds.

Another issue particularly pertaining to investing in equity mutual funds is that India has not seen a long term sustained bull run in equities. Though the longer term equity returns look attractive they have come with higher volatility with sharp rise and deep corrections over short time periods. The bull runs have been typically medium-term, lasting for 2-5 years, unlike the runs seen in gold and real estate or the decade-long Bull Run seen in the USA in the 1990s that created the popular notion of “Stocks for the Long Run”. Compounding this problem is the fact that investors would tend to enter into the equity funds after 2-4 years of the bull run has passed; leaving them at the mercy of the ensuing market correction. This builds a perception that stocks are a speculative asset class with manipulated prices with no intrinsic value.

In general, investors would do well to avoid timing markets and remain invested in a few good diversified equity funds for long-term periods. The long-term argument tends to get contested by investors who, before the recent strong rally, were staring at a flat equity market for the last several years. This would, however, re-inforce the regular averaging benefits that Systematic Investment Plans (SIPs) provide. In fact, investors would do better to stick with their equity SIPs for longer periods, rather than terminating them by getting dissuaded by sideways to downward markets over the short to medium term. The mutual fund industry also needs to change its communication style with investors. Currently the Industry largely refers to short to medium term performance (typically below 5 years) as a selling point. With the industry reaching some maturity as certain funds have been around for over 20 years, it may be appropriate for the industry and its sales advisors to showcase such long term performance to illustrate annual returns as well as the power of compounding. A good example to highlight is the long term performance of SBI Magnum Tax Gain scheme which from its inception in 1993 has delivered annualized return of 16.8% over the last 21 years. This period includes three

large equity bear market corrections but yet the fund returns over the entire period has been quite satisfactory.

Products

Mutual fund industry offers a wide variety of products to suit different investors' risk appetite, desired return and time horizon. Starting from a simple slate of equity and debt funds, today's mutual fund universe includes balanced funds, asset allocation funds, hybrid funds and similar funds that hold securities across asset classes. Further even within a particular asset class, for eg: debt, we now have money market funds, ultra-short funds, short term income funds, gilt funds, corporate opportunity funds, dynamic bond funds, etc. At the same time, several mutual fund schemes have two to three variations on each fund such as growth, monthly dividend, annual dividend, etc.

It is perhaps a misconception that newer products and product categories are essential for growth of mutual fund investor base. Some of the world's largest mutual funds are fairly simple products. For example, the world's largest mutual fund, Vanguard Total Stock Market Index Fund with assets of over $ 300 billion is a passive low cost US equity index fund. The famous Bill Gross managed Pimco Total Return Fund with assets of over $ 200 bn is a bond fund with primary exposure to the US bond market. In India too, it is likely that certain single funds, whether plain vanilla diversified equity or fixed income funds or whether actively managed or passive (index funds or ETFs) could become sizeable with assets over $ 5 billion (Rs 30,000 crores), as domestic savings move to mutual funds.

That being said, there is one asset class which is largely familiar to Indian investors which has not been successfully explored by the mutual fund industry, namely real estate. With rising property prices, ticket size of a single property investment has become out of reach for most investors. Even if an average investor is able to make a single property investment, it may form the majority of his investable assets and hence offers poor diversification within the overall portfolio. Successful real estate investment trust (REIT) and real estate mutual fund (REMF) sold to retail investors with investments as low as Rs 5,000 could be a useful addition to investor portfolios which would give them access to the exposure with low investment sizes. Currently, most of such products are offered by AMCs via portfolio management schemes (PMS) or alternative investment funds (AIF) to high net worth investors.

Another option that should be actively pursued is that of a cash sweep account where excess cash sitting idle in either a brokerage account or bank checking account is automatically moved into a money market account. This offers advantage of higher return and tax benefits coupled with the fact that it is a seamless way to introduce investors to mutual fund products. Charles Schwab, one of the leading players in USA in this space, has more than $ 150 billion in money-market fund assets obtained through sweep accounts.

Technology

The industry faces a significant challenge with respect to penetration into new markets. In the current situation, there is an urgent need to scale up business in cities beyond Tier I, along with retaining existing customers. However, attracting new investors in cities does not come cheaply for mutual fund companies beyond the top 200 districts by GDP. More money has to be spent on distribution and marketing for getting investments in districts with lower income. Technology has the potential to be a game changer here in terms of strengthening distribution network and reaching out to un-banked population in rural areas. Technology can also be a powerful tool in accessing an extremely large pool of Non-resident Indian's savings which can be channelized into Indian capital markets.

Technology through e-finance and internet can reduce distribution and transaction costs, speed up document processing online, provide instantaneous access to information and enable switch over in investment decisions, etc. This, in turn can dramatically improve efficiency and decrease back office costs. Further, the Internet lets mutual funds engage in "one-to-one marketing," allowing them to tailor the online experience to fit unique individual needs.

Increased accessibility to mobile phones and the internet in Tier II and Tier III cities has meant they can be used as a platform to educate consumers regarding products and its benefits. Mobiles powered with the internet can be used as an important information source for unit holders and prospective investors. Mobile or tablet applications can act as a touch point for customers where they can perform transactions. Features like mobile wallet and SMS based investing can make the operational procedure simpler and hassle free for investors in rural areas.

The power of technology and internet in shaping market trends can be seen by the exponential rise in assets of an internet money market fund launched by Alibaba Group in China less than a year ago. At the end of March, just nine months after it opened, the fund had around $87 billion in assets and more than 80 million investors. By comparison, China's A-share equity market has only around 67 million investors after 23 years of development. Investors have been attracted to the online funds by annual interest rates higher than those offered by banks and deposits that can be withdrawn on demand. Even in India, we could potentially see a similar phenomenon where an online platform facilitates investors' access to a competitive mutual fund product.

Retirement Savings

India would benefit from an investment vehicle similar to the 401(k) plan in USA which allows employees to save and invest for their own retirement savings. Similar to India, in USA, interest in equities and related mutual funds waned post the equity bear market of 1973-1974. In 1980, a comparatively miniscule 46 lakh US households owned mutual funds, a 5.7% penetration

rate. However in 1981, IRS issued proposed regulations on 401(k) plans that sanctioned the use of pre-tax employee salary reductions as a source of retirement plan contributions. Many employers replaced older, after-tax thrift plans with 401(k) plans. Within two years, surveys showed that nearly half of all large firms were either offering a 401(k) plan or considering one. By 1990, number of plans with a 401(k) feature ballooned to around 100,000 with 20 million active participants and total assets of $ 385 billion. 401(k) plans allow participants to direct their retirement plan accounts and plan sponsors are required to offer at least three investment options covering a range of risk and return. Since inception, the composition of 401(k) plan assets has increasingly moved toward diversified stock investing, often through mutual funds. In 1989, only 8% of 401(k) plan assets were invested in mutual funds, compared with more than 60% by 2012. As plan participants became increasingly comfortable with long-term investing, equity investments including company stock and mutual funds represented about 61% of 401(k) account balances by 2012. Interestingly enough, even on the heels of two bear markets that lasted from 2000-2002 and 2007-2009, ownership of equity mutual funds among plan participants did not come down significantly indicating a measured response even in the face of significant decline in equity prices. As of end-2013, the size of assets in 401(k) plans was at $ 4.2 trillion with $ 2.7 trillion of this invested in mutual funds (Source: The Investment Company Institute). The situation in India is quite different, where hardly any retirement funds come into mutual funds or equities, with EPFO and pension funds going into debt securities. Even the National Pension Scheme (NPS) has a corpus of Rs 33,000 crores, of which below 10% would be in equities.

In India, such 401(k) type plans would ensure maximum utility of capital- they promote individual savings (employers often match employee contributions), provide incentives to save for long-term and provide disincentives for dissaving (tax on premature withdrawals). Such retirement plans can also serve a balancing role in the equity markets. In US, 401(k) plans control a significant portion of all financial assets. In India, a similar scheme can pool in significant savings and match up to other domestic financial institutions as well as FIIs.

India elected its Prime Minister with unprecedented majority for the ruling party witnessed first time in last 30 years. The government has swiftly flung into action and we expect the government to build serious momentum on ensuring better governance, fiscal discipline and execution machinery. With structural growth drivers firmly in place, a decisive and determined leadership can unleash the entrepreneurial spirit and take the growth potential to the next level. In such a scenario, we expect domestic savings to gradually shift towards productive financial assets. If some of the suggestions mentioned above can be effectively implemented, the mutual fund industry can be a significant beneficiary and its best days lie ahead of us.