Emerging Trends in Mutual Funds

Shekhar Sathe
Chief Executive Officer
Kotak Mahindra Asset
Management Co.Ltd.

Despite the thirty odd years of existence of UTI, the Indian Mutual Fund industry can be termed as young. In fact, so young, that it has just begun to toddle. The insurance companies and many of the nationalised banks promoted their funds about 10 years ago where as other private sector entities have entered the fray only recently. Apart from the skewed ages, market shares are also skewed. To dramatise the awkward market structure : 80% market share is held by UTI. Of what remains, 80% is held by SBI, other nationalised banks and the insurance companies. What remains is 4% with all the privates sector mutual funds.

This situation is at once a threat and an opportunity. It is threat because of the vulnerability of large players who built their business in protected environment and under-developed regulation. To some extent, it is a historical baggage they are carrying which can crush them and the industry if not thrown away carefully and decisively. It is an opportunity because there is room for growth as the large players right-size and as the market also grows. While this happens, all service providers will have to master the first principles of fund management.

The paradigms of fund management are radically changing in India following the historical move towards a market driven economic system. In such a system, flow of capital is mainly driven by the risk-reward perceptions of both, the users and the providers of capital. In our country, banks and financial institutions, under the policy prescriptions of the Government, dominated the intermediation function in all capital flows. The source of capital is essentially domestic and offshore savings. The destination of capital ought to be productive ventures. Under the command economy model, the function of intermediation was dominated by the State Institutions. These institutions, in the course of last few decades, obfuscated the true risk/reward relation in the minds of users and providers of capital. Under the new regime of market forces, the intermediation function will dramatically change as the intermediaries will no longer be able to conceal the risks and mis-pricing of the function of intermediation. The emergence of SEBI and RBI as the supreme watchdogs in this respect heralds this change.

Mutual Funds are going to emerge as a major vehicle for mobilising the savings of the Indian population which in course of time may surpass the role played by conventional banking. Today (including UTI), mutual funds roughly constitute 10% of the total size of deposits in the banking system. This proportion, aided by policy initiatives of the Government and also by better preparedness of the Funds themselves, is bound to increase beyond the expectations many people. This is critical for the health of the banking system. A mutual fund essentially transfers the risk of capital to a unit holder unlike in a bank where the risk gets concentrated on the bank. In a complex and global world, it is unwise for a single intermediary (in the case of India, the banks and institutions owned by the Government) to assume such enormous risk. The mantle is already becoming unbearable. The RBI seems to be very acutely aware of this problem and has been taking decisive steps in recent years. However, RBI's authority is limited to the banking system. UTI is the responsibility of Government of India as it is constituted under a separate act of the Parliament. The committee headed by Mr.Deepak Parekh has provided 'fist aid". The surgery will have to be done by the Government and the patient will have to show prophylactic frame of mind.

If the risk is to be transferred directly to the providers of capital, viz. the unit holders of a mutual fund, then the need to do so with full knowledge of the risk taker takes paramount importance. Also, the role of the fund manager assumes a different proportion and accountability. The mutual funds must stop selling their products as replicates of fixed deposits or debentures. Tax benefits must become icing on the cake and not a cover to hide or camouflage the risky nature of a portfolio. The size of a portfolio needs to be tailored to ability to manage and what the risk class can bear. The valuation of a portfolio has to be realistic and fair. If markets are volatile, the NAVs will be volatile and it makes no sense to hide the volatily from the investors whose capital is at risk. This is especially true of debt funds which are becoming a darling of the market.

Whatever the asset classes, a mutual fund has only three kinds of investors. One is the investor who is entering a fund, second is the one who is staying with the fund and the third is the one who is exiting the fund. It is the fund managers' responsibility to give a fair deal to all. The return any investor gets must come from the market and not from the fellow investors in a scheme. Where such a balance is not achieved, the smart investor will exit and the gullible investor may be left behind holding junk. In a nutshell, the following first principles of fund management and whether or not the mutual funds follow those or not will determine the future of the mutual fund industry.

The first principles exist irrespective of whether the service provider is from the public sector, the private sector or the exalted foreign sector:

1. Define the portfolio well with clear investment objectives.
2. Define the risks associated with such a portfolio.
3. Temper the return expectations to the risk profile of the portfolio.
4. Value the portfolio impartially and objectively.
5. Be transparent about the risks, performance and NAV of the Fund.
6. Service is top priority.

Whether the new trend that is emerging in favour of mutual funds sustains or not will depend on how the funds learn and practice the first principles.

In the Indian context, the Government is the key determinant of this trend. As said earlier, there is a greater realisation that they need to place risk where it should belong. i.e.at the doorstep of the investor and not at its own doorsill. The provision in the recent budget to make dividend tax-free in the hands of investors in mutual funds may have come out of Mr.Parekh's first-aid kit. It may have been passed by default due to the sudden fall of the Union Government and before the banking system and institutions could have their say. But, the end result is a salutary effect on the mutual fund industry. The change has added a new dimension to the function of intermediation in the capital markets. This new dimension essentially lies in the transfer of risk from the intermediary (banks and financial institutions) to the investors. The change will also result in a dramatic reduction in the cost of intermediation. This is particularly evident for the Government itself through the emergence of gilt funds.

The Government through its enormous deficit is the largest claimant of capital. This deficit is mostly raised as debt, the two main sources being banks and direct small savings (contractual and voluntary). Banks collect deposits from the public. Out of such deposits, a substantial portion has to be invested in Government Securities. A Gilt Fund helps channel full savings into Government Securities instead of going through the inefficient intermediation of a commercial bank. If Gilt Funds grow, the Government will have to depend less on banks and banks will have a greater portion of their resources left for their main business of commercial lending. As far as small saving schemes of the Government are concerned, they have an enormous gathering cost which the Government has to bear. If the Government succeeds in helping the Gilt Funds, the cost of gathering will be borne by investors and lead to an enormous saving for the Government. Both the RBI and the Government have recognised the importance of Gilt Funds which is likely to emerge as a major activity in the mutual fund industry. Following the launch of K Gilt, India's first Gilt Fund, several funds are eager to launch similar schemes.

The Gilt Funds should help the industry in quite another way. And, that is, a Government Securities portfolio is the most amenable to demonstrate and practice the first principles of fund management listed above. This will be a great but safe learning experience for investors as well as fund managers. Gilt Funds will help investors manage their liquidity better and in turn could encourage move into other riskier portfolios very smoothly.

Thanks to the entry of foreign majors in the mutual fund market with or without Indian partners, the parameters for competition in the industry are getting laid. All public sector funds and the few left in the private sector will have to recognise the reality and realistically move forward. The main foreign players have an eye on the opportunities that may present in the insurance sector. The mutual fund is perceived as a means of building the marketing capability for the insurance business. The present restrictions of pension funds are bound to be eased. A mutual fund should open the door to pensions which is a mix of insurance and fund management. Given the size of the Indian population and the need for building a social security system, pensions have an enormous potential. Apart from the first principles of fund management, where the mutual funds will have to do hard thinking, is the area of technology required for servicing and cost of such servicing. The acceptance of mutual funds in the near future will first come from the informed or the qualified investor before it becomes a mass product for the emerging players. Therefore the funds will have to first focus at the high end of the market and slowly get on to the mass market. If one were to hazard a potential, the size of the industry can be at least 20% of the bank deposit market in five years. In five years, bank deposits could be somewhere in the region of Rs.14 lakh crore. 20% of this works out to Rs.2.8 lakh crore which is over four times the size of UTI of today!

Such are the emerging trends in mutual funds in India and such is the shape of the subjective and the objective subjective conditions in our rapidly transforming markets.