The Indian Mutual Fund Landscape – The Next 10 Years

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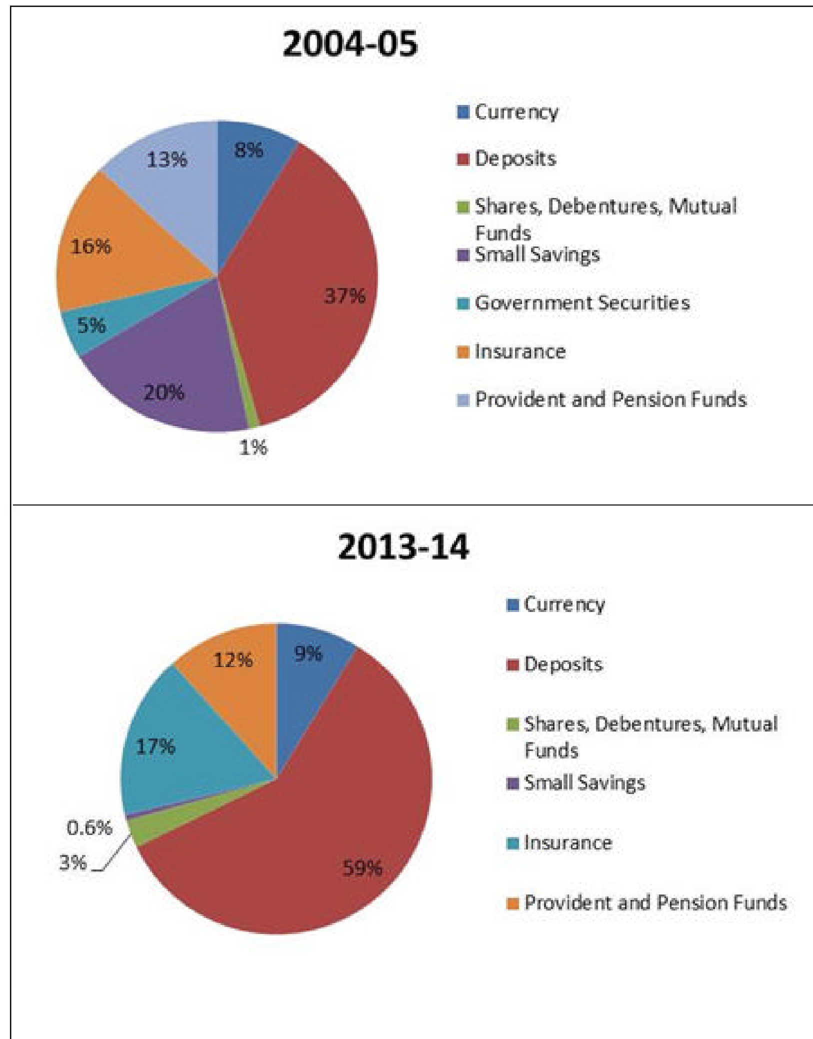
The Indian mutual fund industry has grown by over 7 times from Rs.1.65 lakh cr in June 2005 to nearly Rs.12 lakh cr in June 2015 at an annualised growth of 22%. Surely it is a great feat achieved by the industry. However, when you look at the overall financial savings landscape, the growth is not resounding enough. The charts below show the flow of financial savings across various instruments in the period 2004-05 and 2013-14. In both periods, deposits have the lion's share while mutual funds, shares, debentures have a miniscule share of less than 5% of financial savings. A noticeable shift has been the drop in share of small savings from 20% to less than 1%. The loss in share of small savings has been a gain for deposits. Mutual funds, on the other hand, have not been able to create any major disruption in the wallet share of investors at large over this period.



Source – RBI

With this background, let me talk about a few key aspects about the industry from 2005 onwards (before I delve into the future mutual fund industry landscape) under two broad silios – i) What has changed for the industry and ii) What has not changed for the industry. Some of these aspects would need wider discussion as the industry marches ahead.

What has changed for the Industry			
Highlight	**June 2005**	**June 2015**	**Remarks**
AUM	Rs.1.65 cr	~Rs.12 lakh crore	Grown over 7 times @ CAGR of 22%. Mutual funds are now reckoned as a counterforce to foreign institutional investors in capital markets.
Number of AMCs	30	41	Industry has also consolidated to some extent
Number of folios	1.38 crore*	4.27 crore	Grown by over 3 times or 12% CAGR despite consolidation of folios across AMCs
Number of equity folios^	1.06 crore*	3.47 crore	Grown by over 3 times or over 12% CAGR
Number of Schemes	466	1985	Grown by over 4 times mainly due to closed ended funds
Open ended schemes	415	828	Schemes have doubled and AUM has grown by 7 times.
Closed ended schemes	51	1157	Exponential growth by 23 times following higher upfront commission structures. AUM has grown 13 times.

*March 2005, ^ includes balanced funds

10 Key Regulatory Changes over the past 10 years

1. Entry loads abolished
2. Direct plans introduced
3. Concept of T-15 and B-15 AUM introduced where T-15 is top 15 cities by AUM and B-15 is beyond top 15 cities by AUM.
4. 2 basis points of AUM to be spent for investor education
5. District Adoption Programme (DAP) introduced wherein AMCs adopt less penetrated districts for investor education.
6. Introduction of Gold Funds.
7. Advisor and Distributor norms introduced to bifurcate between advice and distribution. Advisors would be paid fees by investors while distributors would be paid by the manufacturer or AMC.
8. Upfront commissions capped.
9. Fungibility in expense heads of total expense ratio (TER).
10. Transparency drastically increased through disclosures mandated by SEBI, AMFI and pro-bono.

What has not changed for the industry	
Share of Equity oriented funds	Despite two bull cycles, share of equity oriented funds continues to be around 30%
Share of top 15 AMCs by AUM	Industry continues to be dominated by the top 15 players who attract almost 90% of the AUM. 7 of the top 10 players are common in 2005 and 2015.
Penetration is still low vis-à-vis other financial products	1. Mutual funds continue to be a push industry with less than 5% Indians investing in mutual funds. 2. Around 70% of the AUM continues to come from the major metros. 3. Awareness of mutual funds continues to be low. 4. Number of active distributors still very low at less than 15,000 vis-à-vis insurance industry which has over 20 lakh agents*.
Equity funds continue to generate higher inflation adjusted returns	It is a coincidence that 11 schemes which have completed 20 years have given average returns of over 16% for two 10-year periods, one ending on June 30, 2005 and the second ending on June 30, 2015. On the other hand, the Nifty returned 14% in the 10 years ended June 2015 and 9% in the previous 10 year period ended June 2005.

* As reported by Life Insurance Council

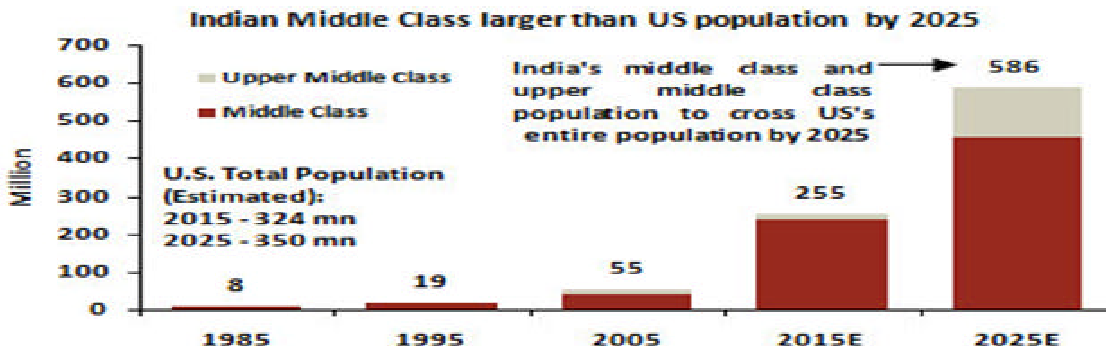
The Industry Landscape in the next 10 Years

Once again, I would put my thoughts about the industry's next 10 year journey in two silos – 1. What would work in favour of the industry and 2. What would be the key challenges?

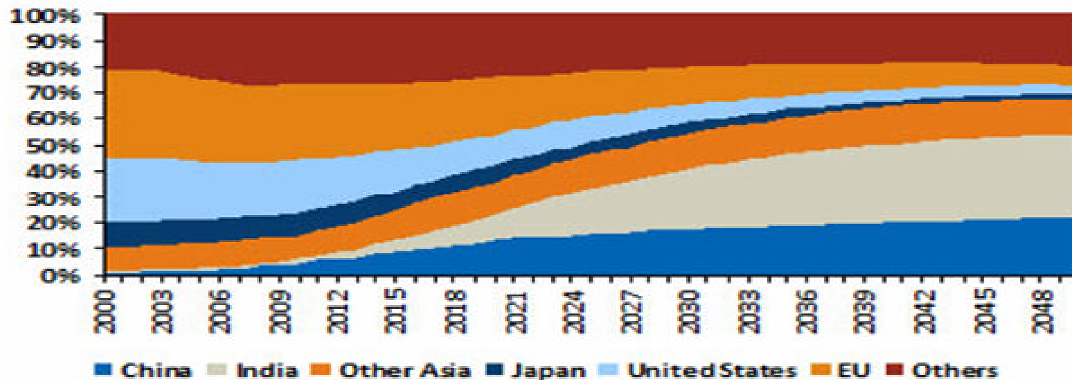
1. Factors working in favour of the industry

a) Demographics of a rising middle class - Since we are in the investment industry, a big factor that would work in our favour would be the rising middle class and tapping their disposable incomes. As seen in the table below, the Indian middle class is expected to more than double over the next 10 years to about 60 crore. In this journey, the Indian middle class would also outnumber the entire US population. The second graph indicates how global middle class spending would shift towards India and China over the next few decades. This would also be because of the increased business focus on emerging markets leading to more jobs and income.

As per the book *'No Ordinary Disruption'*, nearly half of the world's large companies (those with revenues of USD 1 billion or more) would be headquartered in emerging markets. It also states that nearly half of the global GDP growth between 2010 and 2025 will come from 440 cities in emerging markets. Out of these 95% would be small- and medium-size cities. Indian mutual funds must seize this opportunity of tapping the rising incomes of middle class households.



Source: United Nations, McKinsey (ICICI Securities Report)



Source: Economic Intelligence Unit (ICICI Securities Report)

b) Technology – The mutual fund industry is already seeing the impact of technology through social media and platform based transactions which are increasingly influenced by a connected world. The next decade would only see this influence rising. With a mobile subscriber base of 94.3 crore as of end of 2014 and 7 crore mobile internet users (and growing), India is clearly set to gain in terms of mobile internet dominance. It is estimated that every second person in the country will be using the internet over the next 10 years taking the number of mobile internet users to over 60 crore. With the emergence of 4G mobile technologies as well as lowering of smartphone prices, the smartphone would be the fulcrum for all key stake holders – AMCs, distributors and investors.

Technology would also ensure that even investors from India's remotest districts would be able to access mutual funds on their smartphones. This is evident from a recent Café Mutual report which stated that, *"An analysis of Google trends on search queries for mutual funds for the past one year shows that Jharkhand, Goa and Haryana have the highest number of people searching for answers on mutual funds. Among the top 10 cities, Chinchwad (near Pune), Gurgaon and Noida have the highest number of search queries on mutual funds."* Hence, the next growth phase for mutual funds will come from the non-metros as the internet density rises. In short, 'geography' may soon become 'history' as 'm-commerce' takes centre-stage. However, the challenge will be for the AMCs and distribution partners to keep pace with technology as the focus would shift to digital communication to get a share of the investor's savings wallet.

c) Products – With nearly 2000 schemes on offer across 41 AMCs and 3 broad asset classes, a consolidation of products is bound to happen. At the same time, the industry is likely to add asset classes like real estate through REITs and foreign products to its basket. The approach is also likely to be more solution driven rather than product centric. Further, products are likely to get simpler for the mass market with a focus on greater consistency of returns rather than maximization. We are likely to see more pension products being launched to improve longevity of holding. With the commodities regulator merging with SEBI, mutual funds may also add more commodities to the product basket. Innovations may appear in the ETF (Exchange Traded Funds) space both under active and passive management. Mutual funds would thus offer diversification by asset class, geography, currency as well as strategy in a seamless digital world.

2. Challenges over the next 10 years

With higher disposable incomes, technology and products creating the right base for the growth of the industry in the next decade, there would of course be challenges. These challenges can be bifurcated under 3 broad heads – Push, Pull and Operational challenges.

a) Push – Being a push product to be sold across the length and breadth of the country, the industry still needs a wide distribution network as technology is still not well entrenched. The industry is dwarfed in front of the insurance industry which has over 20 lakh agents compared to about 15,000 active mutual fund distributors. Hence there is a dire need to get the two big distribution channels into the mutual fund fold – i) India Post and ii) PSU Banks.

India Post has the largest postal network in the world with over 1.5 lakh post offices across the country. With India Post likely to get a payment bank license from the RBI and its ability to sell financial products like small savings schemes, it has a natural edge to sell simple mutual fund products to the masses. The PSU bank network with nearly one lakh branches is another source that has not been fully utilised to sell mutual funds. Both these readily available networks would spare the industry the cost of creating a new network on its own. The challenge would be to make mutual fund selling remunerative for banks and post offices. The same goes for attracting new distributors. Hence there is a dire need for the industry to think 'out of the box' and make it attractive enough for potential entrepreneurs to look at mutual funds as a viable and profitable occupation.

b) Pull – Mutual funds is a discretionary product and creating a pull for the product is a big challenge. We could look at 3 options to generate pull - i) Standalone regulations to incentivize mutual funds as a pension and annuity product, ii) Include mutual funds in school and college syllabus to educate investors at an early stage and iii) Simplify communication to publicise the performance of mutual funds.

i) **Pension and Annuity -** According to a CRISIL report, 10 crore or a little about 9% of India's population is over 60 years of age and this would rise to 18 crore (over 12% of the population) by 2030. Only government employees get pension in India while the private and unorganized sector needs to build a retirement kitty on their own. Indians typically buy real estate and invest in bank deposits for annuity when they retire. However, both products have their limitations. The mutual fund industry can support this cause if standalone incentives like tax benefits under a dedicated section for mutual fund pension products are made available.

The current section 80C which includes ELSS funds is crowded with many other financial products offering assured returns. The new incentive would be similar to the section 401K in the USA which helps US citizens save for retirement by investing in mutual funds through a salary account. India introduced the National Pension System (NPS) as a defined contribution retirement product but the pull has been limited. It would help if employers can directly credit portion of salaries to a mutual fund account to build a retirement kitty like the way EPFO operates. Employees should also be able to avail exclusive tax benefits for these investments.

ii) **Early stage investor education –** Today all mutual funds spend 2 bps of their AUM every year on educating potential investors understand the benefits of mutual funds. However, to hasten this process so that they start investing in mutual funds from their first salary, relevant education on mutual funds needs to be provided at the school and college level, maybe in the curriculum itself.

iii) **Simplify Advertisement Norms –** A pull factor can also be created by advertising mutual fund performance over the long term in a more easy to comprehend manner. For example the CRISIL-AMFI Equity fund performance index has given returns of 17.53% over the past 10 years till June 30, 2015 and 22.30% returns since April 1997. An investor since 1997 would have thus multiplied his principle by about 40 times compared to just over 5 times in traditional products. While investors understand returns, they fail to catch the impact of compounding over longer periods. They prefer terms like 'number of times the principle' rather than percentage returns. Overall the industry needs more flexibility to communicate to investors with the requisite safeguards.

Another weak link is the 'subject to market risk' disclaimer which is specific only to mutual funds. While this is meant to be a safeguard, many a times it acts as a negative hook for potential investors by highlighting more of risk than the returns.

c) Operational Aspects – This will be a key challenge to be addressed if the industry wants to ease entry of potential investors and create a lasting first impression. There are two areas that could be taken up on priority i) Making Aadhar Card or PAN as the mandatory document for KYC and ii) Accepting a bank KYC as KYC for mutual funds in case of low ticket transactions.

i) **AADHAR Card -** Currently a PAN card is a mandatory document for a mutual fund investor. However, the country has only about 3.5 crore tax payers out of which roughly about 1.5 crore are mutual fund investors. So the industry has already tapped almost 50% of tax payers. Being a discretionary product, this is a good number from a penetration perspective. If the mandatory document shifts to an AADHAR card, the eligible population suddenly shifts from tax payers to non-tax payers which are much larger in number. In India, a substantial percentage of middle class households depend upon agriculture as their primary income. This being non-taxable, they are excluded from the tax net. For such investors, allowing AADHAR cards as the mandatory document would help the industry tap them for mutual fund investments. The super wide gap between tax payers at 3.5 crore and AADHAR card holders at 88 crore is itself an untapped opportunity for the mutual fund industry waiting to be tapped.

ii) **Bank KYC -** The second and simpler way to ease entry barriers is to allow 'Bank KYC' as admissible KYC atleast for low ticket mutual fund transactions to begin with. Since KYC is the first step to mutual fund investing, a smoother process helps to convert potential investors faster. Being a push product, there is a high reluctance among small ticket investors to enter. If bank KYC is allowed even for monthly SIPs upto Rs.1000, the industry would be able garner substantial folios from eligible investors.

Summing up

Over the next decade, the industry will have factors like technology, products, demographics and disposable income working in its favour to widen and deepen the penetration of mutual funds. However, challenges related to push, pull and operational aspects would need to be addressed to seek exponential growth. If these challenges are addressed in a time bound manner, the industry is likely to grow at or above 22% (same as seen in the last decade). This translates into an AUM of close to Rs.90 lakh cr or more by 2025. Can we go higher and touch a century in mutual fund assets by that time? Only time would tell but I would prefer to be optimistic and cheer for mutual funds.