Indian Mutual Fund Industry : Challenges and Road Ahead

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Abstract

Mutual funds as an investment vehicle have currently gained immense popularity in India as reflected in the robust growth levels of assets under management. The Indian mutual fund industry has witnessed a sharp growth in past several years at about CAGR of 28% from 2006-11. However, Indian mutual fund industry is yet to travel a long distance as the contribution of the industry is still less than 0.5% of the global assets under management. Assets under management as a percentage of GDP is less than 5 per cent in India as compared to 70 per cent in the US, 61 per cent in France and 37 per cent in Brazil. The paper attempts to assess the performance of Indian mutual fund industry, its comparison with world markets, challenges faced by the industry and road ahead for mutual fund industry.

Introduction

The entire philosophy of investment revolves around two "R"s –Return and Risk. Every investor wants to adopt a strategy through which he can maximize the first R i.e. return and minimize second i.e. risk. Investors have two options to enter into capital markets. Either they can directly invest their money through primary or secondary markets; else they can go through indirect route i.e. Mutual Funds. Evidently the second route is preferred by the investors i.e. investing through mutual funds or unit trusts as it is called in some parts of world. In today's volatile market environment, mutual funds are looked upon as a transparent and low cost investment vehicle which attracts a fair share of investor's attention helping spur the growth of the industry. Though the number of fund houses is increasing each year in the fast growing Indian economy, only top five players control over half of the country's mutual fund business. An analysis of average assets under management (AUM) by over 40 fund houses shows that the top five layers—Reliance MF, HDFC MF, ICICI MF, UTI MF and Birla Sun Life – together control more than half of total assets managed by the MF industry in India. And putting together, these top five fund houses own assets worth nearly Rs. 4 lakh crore which is about 55 per cent of the average AUM of all the fund houses. A number of new players are entering the field each year. Only recently, capital market regulator SEBI gave its green signal to financial houses like Union Bank of India, India Infoline and Indiabulls to operate MF business. However, despite this growth, penetration levels in India are low as compared to other global economies. Assets under management as a percentage of GDP is less than 5 per cent in India as compared to 70 per cent in US, 61 per cent in France and 37 per cent in Brazil.

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History of Indian Mutual Fund Industry

In India, the mutual fund industry started in 1963 with formation of Unit Trust of India at the initiative of Government of India and Reserve Bank. The first scheme launched by UTI was US-64 which is one of the largest scheme floated by any fund. Indian households started allocating more of their savings to the capital markets in 1980s with investments floating into equity & debt instruments besides the conventional mode of bank deposit. Until 1980s, UTI was the single player in the mutual fund industry & it often determined the direction of the market movements. The first Indian offshore fund, India Fund was launched by UTI in Aug 1986. By the end of 1988, UTI had Rs. 67 bn. of assets under its management & the amount mobilized by it was Rs. 21.75 bn. The second era in the history of Indian Mutual Funds started from 1987 with the entry of Public Sector Mutual Funds in the Indian Capital Market. The first one in the league was SBI Mutual fund in November, 1987 followed by Canbank Mutual Fund (December, 1987), LIC Mutual Fund (1989) & so on. These mutual funds helped to enlarge both the investor community & funds for investment. From 1987 to 1993 the fund industry expanded nearly seven times in terms of Assets under Management from Rs. 6.7 bn to Rs. 47 bn. The most important transition in the mutual Fund Industry happened in the year 1993 when entry to the industry was allowed to Private Sector Funds. Quite significantly, foreign fund management companies were also allowed to operate mutual funds, most of them coming to India through their joint ventures with Indian promoters. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. Also, 1993 was the year in which the first Mutual Fund Regulations came into being under which all mutual funds, except UTI were to be registered. During the year 1993-94, five private sector mutual funds launched their schemes followed by six others in 1994-95. Initially, the mobilization of funds by private mutual funds was slow but later on with the establishment of SEBI people showed confidence in this industry & it started flourishing. Another landmark year in the history of Mutual Fund Industry was 1996 when a comprehensive set of regulations were introduced under SEBI (Mutual Fund) Regulations, 1996. These regulations set uniform standard for all funds with an exception of UTI which was governed by UTI Act. Similarly, the 1999 Union Government Budget took a big step in exempting all mutual funds from income tax. In February 2003, following the repeal of the Unit Trust of India Act 1963, UTI was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India representing broadly, assets of US-64 scheme, assured return and certain other schemes with Assets under Management of Rs. 298.35 bn at the end of January, 2003. The Specified Undertaking of Unit Trust of India functions under an administrator and under the rules framed by the Government of India and does not come under the purview of the Mutual Fund Regulations. The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with Sebi and functions under the Mutual Fund Regulations. UTI Mutual Fund currently has over Rs. 250 bn of assets under its management. In a recent move on 21st September, 2005, the Centre decided to pass on the assets under UTI Mutual Funds to its four sponsors for a consideration of Rs.12 bn.

Performance of Indian Mutual Fund Industry:

Table1: Growth of AUM of Indian Mutual Fund Industry

Year	AUM Rs. in Crore
Mar-65	25
Mar-87	4564
Mar-93	47000
Mar-01	121805
Feb-03	87190
Mar-03	79464
Mar-04	139616
Mar-05	149554
Mar-06	231862
Mar-07	326388
Mar-08	50512
Mar-09	417900
Mar-10	613979
Mar-11	592250

Source: AMFI

The major mobilization in the Indian mutual fund industry started happening at the beginning of last decade wherein AUM increased from over one lakh crores in 2001 to six lakh crores in 2011 (refer table-1). It's a whopping jump of 5 times over a period of 10 years. However, if we compare AUM of last two years, there has been a decline of 3.54% on account of substantial outlflows from equity, liquid and income schemes.

Performance of various schemes: If we compare the performance of mutual fund schemes over the last two years (table 2), we find that both equity and income funds have seen outflows. This is due to the financial year end requirements by banks and corporates leading to redemptions from income and liquid funds. A sharp fall in the equity market as well as spiked yields on the long term debt market during the financial year forced the investors to opt for other alternate asset classes like gold and silver. Maximum growth was observed in AUM of Gold ETFs by 176.7%, while AUM of 'FOF Overseas' dropped the most with 12.2%. The financial year-end AUM of the industry for March 2011 stood at Rs. 5.92 lakh crore, down from Rs. 6.13 lakh crore in March 2010. On a year-on-year basis, the AUM for equity category fell by 2.47% to Rs. 1,69,754 crore. Turbulences in the equity market over the course of the financial year subdued the investors' sentiment that resulted in more redemption on equity side although the primary indices –Sensex and Nifty registered annual returns about 10.93% and 11.14% respectively.

Table 2: Scheme wise Comparison of Mutual Funds

Category	Asset Under Management (Rs. CR)*				Inflow / Outflow (Rs. Cr)**	
	31.03.10	**31.03.11**	**Change**	**Change (%)**	**Net Flow**	**Change (%)**
Income	311,715	291,975	-19,740	-6.33	-36706.92	-11.78
Equity	174,054	169,754	-4,300	-2.47	-13404.58	-7.70
Liquid	78,094	73,666	-4,428	-5.67	-3519.80	-4.51
ELSS	24,066	25,569	1,503	6.25	266.40	1.11
Balanced	17,246	18,445	1,199	6.95	1344.72	7.80
GILT	3,395	3,409	14	0.41	-115.84	-3.41
GOLD ETF	1,590	4,400	2,810	176.73	2248.98	141.45
FOF Overseas	2,862	2,516	-346	-12.09	-906.97	-31.69
Other ETFs	957	2,516	1,559	162.90	1388.20	145.06
TOTAL	**613,979**	**592,250**	**-21,729**	**-3.54**	**-49405.80**	**-8.05**

*= Source AMFI, **= Source SEBI

Folios: The total numbers of investors' folios for Indian mutual fund industry has witnessed a decline of 1.95% to 4.72 crore during the financial year of 2010 – 11 (as per the SEBI data) on account of huge redemptions made on equity schemes.

Table 3: Folios

Financial Year	Equity Oriented Schemes			Financial Year	Debt Oriented Schemes		
	No. of Folios	Change in numbers)	Change (in %)		No. of Folios	Change in numbers)	Change (in %)
2004-05	9,041,075	1,007,507	12.54	**2004-05**	3,245,694	-571,836	-14.98
2005-06	17,238,776	8,197,701	90.67	**2005-06**	2,906,669	-339,025	-10.45
2006-07	25,376,347	8,137,571	47.21	**2006-07**	3,161,389	254,720	8.76
2007-08	37,766,259	12,389,912	48.82	**2007-08**	2,989,743	-171,646	-5.43
2008-09	41,131,623	3,365,364	8.91	**2008-09**	3,299,194	309,451	10.35
2009-10	41,118,785	-12,838	-0.03	**2009-10**	3,738,842	439,648	13.33
2010-11	39,290,289	-1,828,496	-4.45	**2010-11**	4,527,435	788,593	21.09

Financial Year	Grand Total		
	No.of Folios	Change (in numbers)	Change (in %)
2004-05	13,845,292	-798,032	-5.45
2005-06	21,788,215	7,942,923	57.37
2006-07	30,366,707	8,578,492	39.37
2007-08	43,796,078	13,429,371	44.22
2008-09	47,964,617	4,168,539	9.52
2009-10	48,174,920	210,303	0.44
2010-11	47,233,262	-941,658	-1.95

Though there was a notable increase of 21.1% on debt schemes folios, a shrink of 18 lakhs folios on equity schemes led to a fall in total folios after six years. The total number of folios of the industry for the FY 2010 – 11 stood at 4.72 crore folios, down from 4.82 crore in the FY 2009 – 10. Equity category that comprises ELSS and other equity oriented schemes lost 4.45% or 18.28 lakhs of folios to 3.92 crore during the year 2010 – 11. On the other hand, Debt oriented categories observed to have an increase of 21.09% to 45.27 lakhs folios during the financial year due to the increased risk aversion on individual investors' fraternity.

New Fund Offers: Indian mutual fund companies collected Rs. 1,24,890 crore during the financial year 2011 by launching 518 NFOs, out of which 451 funds were Fixed maturity plans (FMPs). The corpus that was collected from NFO FMPs was at Rs. 1,13,416 crore. There were 23 equity oriented NFOs that collected Rs. 3,299 crore during the year.

New funds with special features were also introduced like HDFC came up with cancer cure plan in their mutual fund segment. Funds with quant based investment style like Canara Robeco Large Cap+, Motilal Oswal MOSt Shares NASDAQ-100 ETF, Motilal Oswal MOSt Shares Midcap 100 ETF and MOSt Shares M50 - MOS ETF were also launched.

Mutual Fund's Investment in Debt and Equity Schemes: Mutual funds were net sellers for the second consecutive year in the equity spectrum to the tune of Rs 17,703.90 crore during the financial year 2011 after being the net sales of Rs. 10,161.60 crore in the financial year 2010.The net outflow during the period was a result of gross purchases Rs 1,51,450 crore and gross sales Rs 1,68,695 crore. On the debt front, mutual funds were seen as net buyers over years. MF bought debt securities worth a net Rs. 2,37,981 crore during the financial year 2011. The net inflow during the month was a result of gross purchases of Rs 7,37,783 crore and gross sales of Rs 5,01,548 crore.

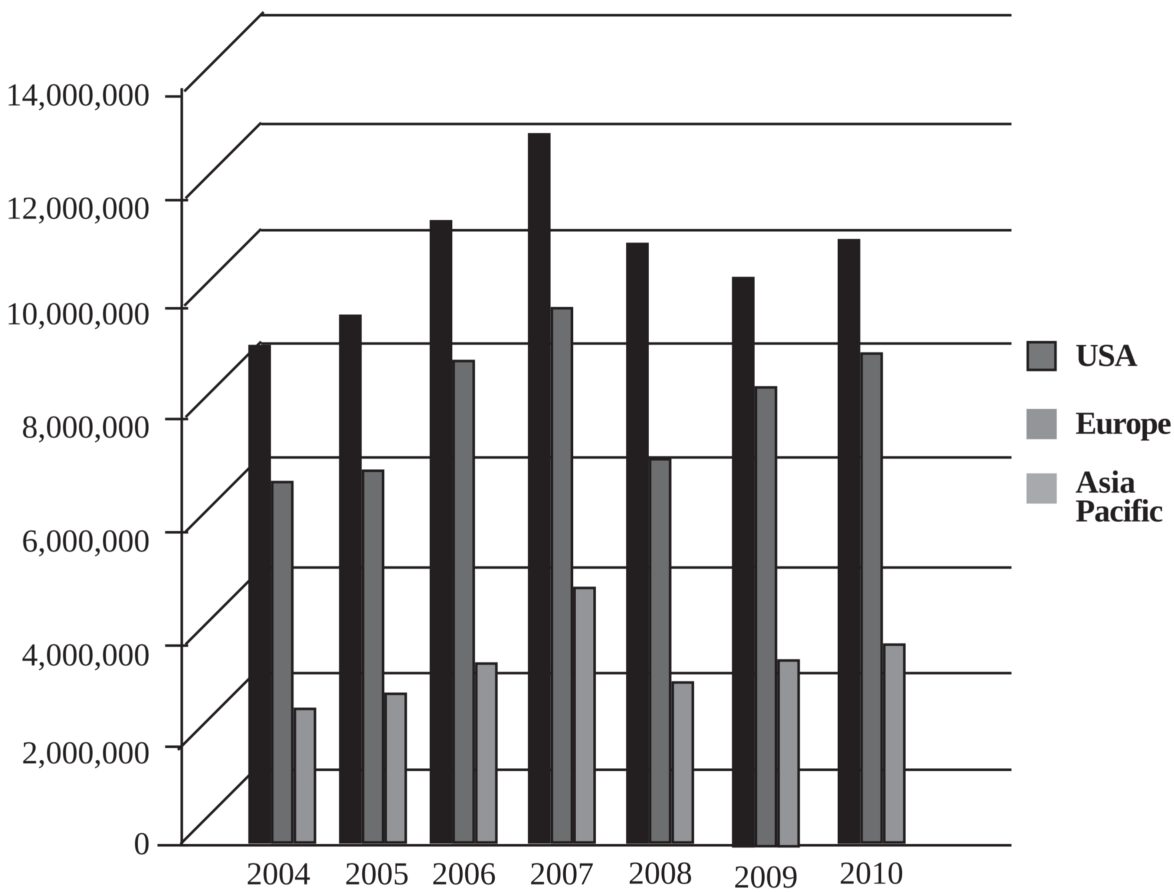
Worldwide Comparison of Mutual Fund Industry

The net assets under the management of the worldwide mutual fund industry were over $24tn in FY 2010. The largest share in the pie is of USA which accounts for almost 46% ($11 trillion) of asset under the management followed by Europe which accounts for around 30% ($ 7 trillion) of world's asset under management. Asia pacific region accounts for a mere 12.5% share out of which India has shares less than 0.5% ($111 bn) of asset under management. It is quite surprising to know that India accounts for about 17% of world population and its share is in the mutual fund Industry is less than 0.5%. Among the Asia Pacific region itself, India accounts for only 4% of Asset under Management whereas Australia contributes 47% of asset under management of Asia Pacific region. Considering the demographic condition where almost 65% of population is working, there is humongous opportunity available for the Indian mutual fund industry to expand its investor base and share in world market. Industry experts also feel that Indian mutual fund industry can grow at a rate of 15% to 25% in next five years if it can increase penetration level.

Table 4 : Compariosn of Asset under Managemnt of Asia Pacific Region for 2010

Australia	0.47
China	0.12
India	0.04
Japan	0.26
Korea, Republic of	0.09
New Zealand	0.01
Pakistan	0.00
Philippines	0.00
Taiwan	0.02

Table 3 : Worldwide Comparison of AUM :



Source : 2011 Investment Company Fact Book

Comparison of Asset under Management of Asia Pacific Region for 2010

Source : 2011 Investment Company Fact Book

Challenges in Indian Mutual Fund Industry

Though Indian Mutual Fund Industry has grown at an impressive rate in last few years, the global economic crisis has impacted fortunes of industry resulting in decline of AUM and adversely impacting the revenue and profitability. Some of the key challenges faced by the industry preventing to harness its growth potential are:

- **Low level of customer awareness:** Low customer awareness levels and financial literacy pose the biggest challenge to channelize household savings into mutual fund industry. A large majority of retail investors lacks an understanding of risk- return, asset allocation and portfolio diversification concepts.

- **Limited focus on increasing retail participation:** Indian mutual fund industry is concentrated in the tier 1 towns only and limited efforts have been made to penetrate into Tier 2 and Tier 3 towns. Large size, tax arbitrage available to corporates on investing in money market mutual funds, easy accessibility to institutional customers concentrated in Tier 1 cities are the factors instrumental in mutual fund houses focusing on institutional segment.

- **Limited innovation in product offerings:** Indian mutual fund industry has largely been product focused and not sufficiently customer focused. Products that cater specifically to customer life stage needs such as education, marriage and housing are yet to find their ways in the Indian market. Indian market is yet to see the launch of green funds, socially responsible investments and hedge funds.

- **Limited flexibility in fees and pricing structures:** The fee structure of Indian mutual fund industry enjoys little flexibility unlike developed markets where level of management fees depends upon a variety of factors like investment objective of the fund, the fund performance, nature and number of services etc that a fund offers.

- **Limited customer engagement:** Mutual fund distributors have been facing questions on their competence, degree of engagement with customer and value provided to the customer. In the absence of framework to regulate distributers both the distributers and mutual fund houses have exhibited limited interests in continuously engaging with customers post closure of sales.

Road ahead for Mutual Fund Industry

The way forward for the next couple of years for the mutual fund industry would be influenced hugely by the journey undertaken till this point of time and the changing demographic profile of investors. There are needs both at the mutual funds well as at the regulators side to lay down a successful road ahead of mutual funds by taking following measures:

- **Diverse Range of Products:** There is a need for Indian MFs to come out with innovative products that cater to requirements of ever changing customer. In US, MF products tailored for the entire life cycle of the investor. Diversified products will keep the present momentum going for the industry in a more competitive and efficient manner.

- **Regulation for MF Distributors:** Currently, distributors of MF schemes are not separately regulated by any authority in India. Further, many of them though certified by AMFI still leave a lot to be desired so as to render professional advice to the investor and reduce mis-selling of the MF products. MFs need distributors who are able to inform the investors about the efficacy of the product for a particular risk profile and stage in their life cycle.

- **Recommendations to re-visit the eligibility norms of AMCs:** SEBI had constituted the "Committee on Review of Eligibility Norms" (CORE) to re-visit the eligibility norms and other functional aspects prescribed for various intermediaries. Amongst other recommendations, the key ones are relating to increase in the minimum net worth of AMCs from the existing Rs. 10 crores to Rs. 50 crores, change in the definition of net worth, sponsor to be a regulated entity and change in definition of control. The objective of the proposed recommendations is to allow only the serious players to enter/ remain in the market.

- **Real Estate Mutual Funds:** Real Estate Mutual Funds could be the next big thing for the industry provided the regulators bring in more clarity on the tax and regulatory aspects.

Conclusion

India is undoubtedly emerging as the next big investment destination riding on a high savings and investment rates as compared to other Asian economies. Over 50 per cent of the population is less than 25 years of age with the proportion of working population likely to increase significantly over the next decade. The trend of rising personal incomes have been witnessed not only amongst the young population, but also the high net worth (HNI) segment which has sizeable sums to invest. Indian mutual fund industry has travelled a long distance since its inception in 1963. However, there is still a lot to be achieved in comparison to mature markets like U.S. and Europe. Though, it is commendable to note that Assets under Management have managed to record a compounded growth of 28% over 2006-2010, however, the AUM of Equity Funds and Balanced Funds where retail investors invest have only grown by 20% in the same period. Indian mutual fund industry is yet to leave a mark as this still contributes less than 0.5% in the global asset under management. If the above mentioned reforms are undertaken, it's a matter of time that mutual funds will find an important role in our capital market. Indian mutual fund industry is still in its growth face and has huge potential to grow if one can develop trust and awareness among investors to adopt this route for investment.

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