SPEECH

Rethinking the Awards Regime for Mutual Funds*

Good evening movers and shakers of the Indian mutual fund (MF) industry. This financial year started off with an AUM (assets under management) of Rs. 5.05 lakh crore and at the end of February 2009, it was Rs. 5.09 lakh crore, I am sure the March 2009 end figures would be higher. What is important to note is that the AUM did not diminish, despite the huge contraction of the domestic financial markets during this period. The MF industry also witnessed some tremor, but it successfully weathered thanks to the excellent stewardship of the captains of the industry. Thanks to them, the industry has seen impressive growth in terms of number of mutual funds and schemes, number of unit holders, assets under management, etc. I feel proud that I am here today to salute these captains.

I know, the CNBC-TV 18 and CRISIL are recognizing and awarding the Olympic Spirit of Higher, Faster, Stronger; these are for excellence in performance in the different segments, such as equity, income, diversified, short term, long term, etc. These are like the best scores in academics such as in Maths, English, Science, etc. Though these are very important, these academic scores do not fully capture or reflect a student. Similarly, excellence in performance in equity and debt schemes does not fully reflect a MF. There are other vital aspects. We need to recognize and honour the MFs in those aspects also. For example, we should recognize the most transparent fund, that is, the MF which strives for transparency much beyond the call of the SEBI Regulations. In the long term interest of the MF industry, I am going to suggest awards for a few more categories.

All India MF

First, let us recognise the MF with the maximum all India presence. We belong to the securities market, which is truly national. The MF industry should also be a national one. Most of the funds, however, have their sales offices in the top 10 cities. About 90 per cent of AUM of most of the funds come from the top 10 cities. According to CDSL Ventures, which does the KYC of the MF investors, about 90 per cent of the investors come from urban and semi-urban areas. According to a McKinsey study, 74 per cent of even the retail AUM comes from the top 8 cities. This means that a large section of the society is outside the purview of the MF industry. I think, every MF should have investors from all over the country. We should have all India funds, in contrast to city - or Mumbai-based funds. Please note that we are extending the new pension scheme to all Indian citizens from 1st May with points of presence / sales in every district in India. We must, therefore, recognize the mutual fund which has the maximum all India presence in terms of investors located in the maximum number of Pin Codes.

Retail Individual Investors

We are recognizing the MFs for excellence in wealth creation. The question is: Whose wealth? Is it that of the AMC, distributor, corporate investor, high networth individual, or retail individual investors (RIIs)? I think, it should primarily be that

* Speech delivered by Shri M. S. Sahoo, Whole Time Member, SEBI at the CNBC-TV 18 – CRISIL Mutual Funds Awards Function on March 31, 2009.

of the RIIs who do not have the wherewithal to participate in the market directly. An apparent paradox in India is the high rate of domestic savings and a reasonably modern and efficient financial markets, and yet very low allocation of household savings to financial assets. Only half of the household savings goes into financial savings. 7.7 per cent of the financial savings went into mutual funds in 2007-08. The AUM of the industry is about 8 per cent of the GDP. According to a survey by India Invest Economic Foundation, only 5.3 million individuals invest in MFs as compared to the total working population of 321 million. It is reasonably evident that a large proportion of the Indian households are not using the financial markets and those who are, are not using the mutual funds. About four-fifths of the AUM is in liquid and debt funds. These typically come from non-retail investors. Banks alone account for 18 per cent of the AUM. Corporates account for 60 per cent of the AUM of the industry. Individuals, including NRIs and HNIs, account for the balance 40 per cent. The data for RIIs are not separately available. The guess puts it around 15 per cent. Thus, the conclusion is that the RIIs are also investors in the industry. This calls for awarding the MF which has relatively the maximum retail participation and, therefore, creates wealth for the people who cannot do it on their own. By this, I am not trying to say that the award alone would bring in the RII focus or that the MFs should not create wealth for others.

Churning of Portfolio

MFs are primarily investment vehicles. The kind of churning, that happens in the MF industry, gives an impression that it is a trading industry. During this year, the industry churned its equity portfolio twice. Institutional investors generally do not do such huge churnings and that too, when the market turnover ratio is about one. Please note that such churning involves cost. Further, the investors in MFs buy today and sell tomorrow. The turnover (sales and redemption) during this year is about Rs. 100 trillion, while the net inflow is only Rs. 70,000 crore and the AUM at the end of February 2009 was Rs. 5.09 lakh crore. In the eleven months of this year, the investors have churned the AUM 20 times. What is worse is that the churning is increasing over the years. The out-of-pocket expenses including entry/exit loads, statutory levies and intermediary fees and processing costs associated with churning on both sides must be sizable though we do not have the figures of such costs in the public domain. But somebody is bearing the costs associated with these transactions and that somebody is ultimately the investors themselves. It may be useful to reward the mutual fund which has the least such costs. This would reward not only efficiency, but also efficacy.

Too Much of Choice

The 1990s witnessed the emergence of a variety of funds. There are funds which invest in growth stocks, funds which specialise in stocks of a particular sector, funds which invest in debt instruments and funds which invest aggressively and funds which do not do all these. Thus, we have income funds, balanced funds, liquid funds, Gilt funds, index funds, sectoral funds and there are open-ended funds, close-ended funds and fund of funds - there is a fund for everybody and for every need. The number of schemes at the end of February 2009 was close to 1,000, equal to the number of securities listed on the NSEIL. The small investor has no means to know which fund or scheme to choose. He likes choice, but in this case he is lost with too many choices. To complicate his life further, a scheme has sub-schemes, which has different plans (wholesale, deposit, institutional), different options (dividend, growth, bonus), option variants (quarterly, annual), different AMC fees, etc., 1,000 schemes may have in all about 5,000 products. A small investor earlier had problem in choosing out of 2,000 securities, now he has to choose out of 5,000 MF products and 2,000 securities. He wanted relief from the deep sea, but ended up between the deep sea and the devil. The choice is difficult; he is not making any choice. He is investing in MFs and also investing in securities directly. Probably, the industry needs to provide a few simple standard products which suit the needs of the majority of the small investors. In addition, they may provide niche products of different complexities for those who can understand. The MF, which provides the simplest products, needs to be recognized.

Personal Finance

I hear the argument that MF does not have a level-playing field with the insurance industry. The argument is that the insurance products pay out 30 per cent commission on some products while the MFs cannot pay beyond 3 per cent. While I do not entirely agree with the argument, I would think, this puts MFs in an advantageous position. This is because the MF industry gets to invest Rs. 97 out of every Rs. 100. In contrast, the insurance industry gets to invest Rs. 70 out of every Rs. 100. The only problem associated with this is the illusion of the investors. It is the job of the MFs to remove this illusion. They need to educate investors, in addition to marketing their products. I, however, see a lot of focus MFs have on marketing and very little on investor education. In fact, one contributory factor to the financial crisis is the failure to distinguish between promotion campaigns and education campaigns. Marketing of products ranging from credit cards to complex structured products were passed on as awareness campaigns. These efforts aimed at enrolling more and more people into the financial markets by maintaining a deafening silence on their flip side. These marketing-led education drives have prompted regulators like the Financial Services Authority of U.K. to come out with what they call 'neutral' financial education drives. Such drives pitch fork “no sales, no jargon, only facts”. I would call upon the MFs to be aggressive in 'only facts' investor education. When I am suggesting this, I am fully aware that investor education is a social infrastructure where private costs exceed private benefits. That is why, I propose a Public-Private Partnership (PPP) model for spreading investor education, as we have adopted the PPP model for governance of the markets. Given the complex world of markets and products and also a variety of niche market segments, one agency cannot make an impact by itself. We need to team up with other organizations that have goals similar to ours - not necessarily the same goals - and identify ways to work together. It has to be a major initiative of regulators and market participants, including MFs, across the market. I would, therefore, like to award the MF which makes the maximum efforts towards 'only facts' investor education and awareness.

Thus, I would suggest for the consideration of the organizers, of course for the future, for recognizing excellence in transparency, all India presence, retail participation, cost of churning and investor education, in addition to awards for being faster, higher and stronger. Thank you, CNBC-TV 18 and CRISIL, and congratulations to all the winners.

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