

Rethinking the Award Regime for the Mutual Funds Industry

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The current financial year started off with an AUM (assets under management) of Rs. 5.05 lakh crore and at the end of Feb 2009, the figure was Rs. 5.09 crore. 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 mutual fund (MF) industry also witnessed some tremor, but it successfully weathered the shocks. The industry has seen impressive growth in terms of number of mutual funds and schemes, number of unit holders, assets under management, etc. over the years.

While it is customary to acknowledge and reward MFs for performance in different segments such as equity, income, short term, long term etc; there remain other vital aspects which also need to be recognized and rewarded.

Transparency

Many details of MF industry are not available in public domain. This restrains the investors,

regulators and policy makers from taking appropriate decisions. For example, the shares of top 'N' unit holders in the AUM, of top 'N' distributors in gross sales, and top 'N' investments in the portfolio of every scheme, fund and the MF industry as a whole and qualitative details of these top 'N' unit holders, distributors and investments are important inputs for decision making. The scheme wise and fund wise details of rural participation, national presence, cost of management and distribution, churning, NPAs, investor education, etc. are also relevant details. We should recognize the most transparent fund, that is, the MF which strives for transparency much beyond the call of the SEBI Regulations.

National Presence

First, let us recognize the MF with the maximum all India presence. The Indian securities industry is sub-continental in its dispersion, and this should reflect in the reach



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of the MF industry too. A look at the statistics pertaining to the industry would reveal that this is not quite the case.

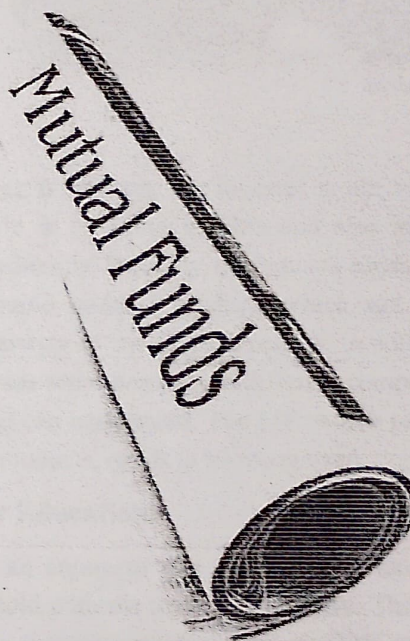
Most of the funds have their sales offices in the top 10 cities. About 90% of AUM of most of the funds comes from the top 10 cities. According to CDSL Ventures, which does the KYC of the MF investors, about 90% of the investors come from urban and semi-urban areas. According to a recent McKinsey study, 74% 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. It is desirable that every MF has investors from all over the country. The MF industry should pride in all India funds, in contrast to city- or Mumbai-based funds. The other segments of the financial market such as banking and insurance have much wide dispersion. The emerging new pension scheme is being made available to citizens all over India from 1st May with points of presence/sales in every district in India. We must, therefore, recognize the MF which has the maximum all India presence in terms of investors located in the maximum number of Pin Codes.

Retail Participation

Generally, MFs are recognized for excellence in wealth creation. The question is: Whose wealth? Is it that of the AMC, distributor, corporate investor, high net worth individual, or retail individual investors (RIIs)? I believe, it should primarily be that 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 reasonably modern and efficient financial markets, and yet very low allocation of household savings to financial assets. Only half of the household savings go into financial savings. 7.7% of the financial savings went to mutual funds in 2007-08. The AUM of the industry is about 8% 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 MFs. About four-fifths

of the AUM is in liquid and debt funds. These typically come from non-retail investors. Banks alone account for 18% of the AUM. Corporates account for 60% of the AUM of the industry. Individuals, including NRIs and IIIs, account for the balance 40%. The data for RIIs are not separately available. Estimates suggest it would be around 15%. 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.



Portfolio Churning

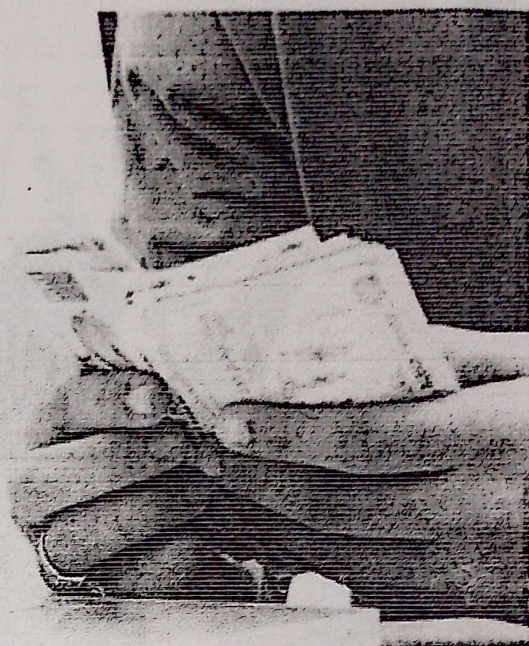
MFs are primarily investment vehicles. The kind of churning, that happens in the MF industry, gives an impression that it is a trading industry. During 2008-09, the industry churned its equity portfolio twice. Institutional investors generally do not do such huge churning and that too, when the market turnover ratio is about 1. It is important to note that such churning involves cost. Further, the investors in MFs buy today and sell tomorrow. The turnover (sales and redemption)

during 2008-09 is about Rs. 100 trillion, while the net inflow is only Rs. 70,000 crore only and the AUM at the end of February 2009 was Rs. 5.09 lakh crore. In the eleven months of 2008-09, 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 intermediation charges 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 MF which has the least such costs. This would reward not only efficiency, but also efficacy.

Excessive 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, there are 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 1000, equal to the number of securities listed on the NSEIL. The small investor does not have the skills to choose the best option from among these funds and schemes. 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. 1000 schemes may have in all about 5000 products. A small investor earlier had problem in choosing out of 2000 securities, now he has to choose out of 5000 MF products and 2000 securities. He wanted relief from the deep sea, but ended up between the deep sea and the devil.



The choice is difficult; the investor 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.

Investor Education

There is an argument that MF does not have a level-playing field with the insurance industry. The argument is that the insurance products pay out 30% commission on some products while the MFs cannot pay beyond 3%. While this is not entirely correct, 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.

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 for "no sales, no jargon, only facts". Indian MFs need 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 financial 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, it would be useful to recognize MFs for their excellence in transparency, national presence, retail participation, portfolio churning, simple products and investor education, in addition to awards for the usual categories for which MF performance is normally recognized and rewarded.