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C H A P T E R

FUND STRUCTURE AND CONSTITUENTS

"The mutual funds can be organised in two ways. One, the Trust structure and the other, the Company structure. In both these structures, there is an entity which undertakes the designing and marketing of schemes, raises money from the public under the schemes and manages the money on behalf of its owners. This entity is the fund manager or an Asset Management Company (AMC). To segregate the collected funds from this entity's own funds, the corpus is placed in a legal vehicle. It is the character of this legal vehicle that determines the character of the Fund itself. If this vehicle is a corporate entity then the fund acquires the name of an investment company as in the US and UK and if the entity is a Trust, the fund acquires the name of mutual fund as in UK and India, for example. Irrespective of the nature of the structure, what is more fundamental is that in view of the fiduciary role of the AMC or the fund manager towards the public, there is a need for supervision of the activities of the AMC or fund manager by a separate body. This supervisory role is fulfilled by the Board of Trustees and in a corporate structure by the Board of directors of the Investment company."

Indian Mutual
Funds

Trustee
Company,

Company and

Mutual Funds in India have a 3-tier structure Sponsor, Trustee & AMC or Asset Management Co.

18 Fundamentals of Mutual Fund

- The investor's money is held in a trust (the mutual fund) In India, the mutual fund is formed as a Trust under the Indian Trust Act, 1882
- The board of trustees is accountable to the Office of the Public Trustee, in turn reporting to Charity Commissioner
- The trust represents the investors themselves and is only a pass-through vehicle
- In US, mutual funds are formed as investment companies
- In the UK, MFs have two alternative structures: Open ended in the form of Unit Trusts & Close-ended in the form of Corporate Entities.

SPONSOR

- Sponsor is the promoter of the Mutual Fund
- Sponsor creates the AMC and the Trustee company and appoints the directors to these companies with SEBI approval
- Sponsor should have at least 5 years track record in the financial services business and should have made profit in at least 3 out of the 5 years_Sponsor should contribute at least 40% of the capital of the AMC
- Sponsor could be a bank (SBI, PNB, ICICI), a financial institution (Fidelity, Franklin Templeton) or a Corporate (Reliance, Birla, Tata etc.).

TRUSTEES

- The role of the Trustees is to safeguard the interest of the investor/unit-holder of the fund Fiduciary Capacity
- The trustees make sure that the funds are invested according to the investor's mandate and objective
- The board of trustees is appointed by Sponsor with SEBI approval_At least 4 trustees of which at least 2/3rd of the board of trustees should be independent
- Trustees of one mutual fund cannot be trustee of another mutual fund
- Right to seek regular information and remedial action
- All major decisions need trustee approval
- The board of trustees are required to meet at least 4 times in a year to review the AMC
- Trust created through a document called the 'Trust Deed', executed by the Fund Sponsor in favour of the Trustees.

ASSET MANAGEMENT COMPANY

- Registered with SEBI
- The AMC is also formed as a private limited company
- Responsible for operational aspects of the MF
- Investment management agreement with trustees

- The AMC gets fee for managing the funds according to the mandate of the investors.
- An AMC's net worth (Share Capital + Reserves & Surplus) should be at least Rs. 10 crores at all times
- At least 40% of AMC capital must be contributed by the Sponsor
- At least half (50%) of the directors of the AMC must be independent
- Appoints other constituents - Custodian, Registrar & Transfer Agent
- Cannot have any other business interest
- AMC of one MF cannot be trustee/AMC of another MF
- Quarterly reporting to Trustees
- AN AMC cannot engage in any business other than portfolio advisory and management.

CUSTODIAN/DEPOSITORY

- The custodian is appointed for safekeeping of securities and participating in the clearing process
- The custodian is the guardian of the funds and assets of investors
- The custodian maintains the accounts of securities, their transaction and balance sheet etc.
- The custodian and sponsor cannot be the same entity Registrar and Transfer agent
- manage the sale and purchase of units and keep unit-holder accounts Ex: Karvy and CAMS

Broker: Purchase and sale of securities_5% limit per broker

Auditor: Separate auditor for AMC and Mutual fund.

Mutual Fund Service Providers

Mutual funds differ from typical corporations in a very significant way – they are not managed internally. Mutual funds are basically shell entities holding securities, for which administrative, investment, and legally required functions are provided by external *service providers* (subcontractors). Investment management companies sponsor, organize, and arrange for provision of services required by funds. They act as fund investment advisors and provide the essential research and portfolio management services consistent with fund investment objectives, policies, and limitations.

The specifics of services provided by mutual fund service providers vary, but a general description follows:

1. **Investment advisor:** provides research and portfolio management services consistent with fund investment objectives, policies, and limitations as stated in the prospectus; functions include formulation and implementation of investment style and strategies, security analysis, market and economic analysis, portfolio allocation, security buy/sell decisions, and performance evaluation.
2. **Administrator:** provides management and regulatory oversight; reviews and reports performance of other administrative service providers and ensures fund regulatory compliance; may pay office, equipment, and personnel expenses; may provide general accounting services and prepare/file SEC, tax, shareholder, and other reports.
3. **Custodian:** holds portfolio cash and securities in safe keeping; settles portfolio transactions – receives cash and securities and makes authorized cash payments and security deliveries; collects portfolio interest and dividends; pays authorized expenses, shareholder redemptions, and disbursements; and maintains related records.
4. **Transfer agent:** fulfills shareholder transaction requests and receives and authorizes disbursement of monies from shareholder transactions; maintains and provides shareholder account and transaction records; provides a wide range of shareholder services; provides shareholder communications, including account and transaction statements, annual and semi-annual reports, prospectus, proxy statements, and informational material; often serves as disbursing agent for shareholder distributions.
5. **Distributor (principal underwriter):** as broker-dealer provides direct and/or indirect distribution of shares to investors; distributes fund publications; and provides fund marketing and advertising.

Mutual fund service providers. Management company: portfolio management. Administrator: administration and management/regulatory oversight. Auditor: accounting compliance. Legal counsel: legal compliance. Transfer agent: transactions, accounts, and services. Custodian: safeguard assets. Principal underwriter: distribute shares.

- (a) 5% of the corpus of the scheme
- (b) 5% of the paid up capital of the company
- The maximum investment by a mutual fund under all of its schemes put together in the shares of a listed company can not exceed 10% of its aggregate corpus of all the schemes put together. Subject to the overall limit of 10% of the paid up capital of the investee company
- A mutual fund can transfer the funds from one scheme to another scheme by purchasing the units of another scheme not exceeding 5% of the corpus of the scheme, in which such an investment is being made

5. Advertisement Code of Conduct

Every mutual fund should follow the code of conduct while advertising for the schemes as laid down by SEBI from time to time. Advertisement for the schemes shall give full details about the sponsor – its background, past track record, affiliation, etc. The offer document shall also contain details about the functioning of the scheme, AMC, custodian and other activities of the mutual fund organization. The mutual fund should mention about 'risk factors' if investment is made in the scheme.

6. Disclosure of NAV

Mutual fund organization has an obligation to disclose NAV of all the schemes individually at a regular time interval as specified by SEBI from time to time. It should also disclose investment pattern under every scheme. At present, all these are to be disclosed weekly.

$$\text{NAV} = \frac{\text{Market value of Investment under the Scheme} + \text{Net Receivables} + \text{Cash}}{\text{Number of Units under the Scheme}}$$

7. Winding Up

- *Close-ended scheme*
A close-ended scheme should be wound up at the time specified in the offer document, unless a permission for the rollover of the scheme has been taken from SEBI or the authority concerned
- *Open-ended scheme*
An open-ended scheme doesn't have a maturity period; therefore, in normal circumstances, there is no winding up of such a scheme. However, such a scheme is to be wound up compulsorily, if at any time corpus of the scheme falls below 50% of the original corpus. By original corpus, we mean the funds pooled during the initial 45 days of the opening of the subscription for the scheme.

Types of Mutual Funds/Mutual Fund Schemes

- Open-ended fund
- Close-ended fund
- Growth fund
- Equity fund
- Balanced fund
- Money market mutual fund
- Equity-linked scheme
- Infrastructure fund
- Debt fund
- Income & Growth fund
- Income fund
- Power mutual fund
- Index fund
- IT fund
- Funds of fund
- Dynamic fund

Mutual fund schemes may be classified on the basis of its structure and its investment objective

Classification of MF based on structure

An open-end fund is available for subscription throughout the year and does not have a specified maturity period.

Open-ended Funds An open-ended fund is one that is available for subscription throughout the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value (NAV) related prices. The key feature of open-ended schemes is liquidity.

Sale price = NAV + Entry load

Re-purchase price = NAV – Exit load

The fund is open for subscription only during a specified period and has a specific maturity period.

Closed-ended Funds A closed-ended fund has a stipulated maturity period, which generally ranges from 3–15 years. The fund is open for subscription only during a specified period. Investors can invest at the time of the initial public issue and thereafter, they can buy or sell the units of the scheme on the stock exchanges where they are listed, or investors can sell these if repurchase option is provided. In order to provide an exit route to the investors, some close-ended funds give an option of selling back the units to the mutual fund through periodic repurchase at NAV-related prices. SEBI Regulations stipulate that at least one of the two exit routes is provided to the investor.

Interval funds combine features of open-ended and close-ended schemes.

Interval Funds Interval funds combine the features of open-ended and close-ended schemes. They are open for sale or redemption during pre-determined intervals at NAV-related prices.

Classification of MF Based on Investment Objective

Growth Funds The aim of growth funds is to provide capital appreciation over medium to long-term. Such schemes normally invest a majority of their corpus in equities. It has been proven that returns from stocks have outperformed most other kind of investments held over the long-term. Growth schemes are ideal for investors having a long-term outlook, seeking growth over a period of time.

The aim of growth funds is to provide capital appreciation over the medium to long-term.

The aim of income funds is to provide regular and steady income to investors.

Income Funds The aim of income funds is to provide regular and steady income to investors. Such schemes generally invest in fixed income securities, such as bonds, corporate debentures and government securities. Income funds are ideal for capital stability and regular income.

The aim of balanced funds is to provide both growth and regular income.

Balanced Funds The aim of balanced funds is to provide growth and regular income. Such schemes periodically distribute a part of their earning and invest both in equities and fixed income securities in the proportion indicated in their offer documents. In a rising stock market, the NAV of these schemes may not normally keep pace, or fall equally when the market falls. These are ideal for investors looking for a combination of income and moderate growth.

Money Market Funds The aim of money market funds is to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer short-term instruments – treasury bills, certificates of deposit, commercial paper and inter-bank call money market. Returns on these schemes may fluctuate, depending on the interest rates prevailing in the market. These are ideal for corporate and individual investors as a means to park their surplus funds for short period.

Load Funds A Load Fund is one that charges a commission for entry or exit. That is, each time one buys or sells units in the fund, a commission need to be paid. Typically, entry and exit loads range from 1-2%. It could be worth paying the load, if the fund has a good performance history.

No-load Funds A No-load Fund is one, that does not charge commission for entry or exit. That is, no commission is payable on purchase or sale of units in the fund. The advantage of a no-load fund is that, the entire corpus is put to work.

Other Schemes

Tax-saving Schemes These schemes offer tax rebates to investors under specific provisions of the Indian Income Tax laws as the government offers tax incentives for investment in specified avenues. Investments made in

Equity Linked Savings Schemes (ELSS) and Pension Schemes are allowed as deduction u/s 88 of the Income Tax Act, 1961. The Act also provides opportunities to investors to save capital gains u/s 54EA and 54EB by investing in mutual funds.

Industry-specific Schemes Industry-specific Schemes invest only in the industries specified in the offer document. The investment of these funds is limited to specific industries like InfoTech, FMCG, pharmaceuticals, etc.

Index fund Index funds attempt to replicate the performance of a particular index, such as the BSE Sensex or the NSE 50

Performance Evaluation of Mutual Funds/Managed Portfolio

A managed portfolio is the one, which collects the funds from investors in the form of different schemes with the objective of investing these funds in the capital/money market. The benefits generated from this investment activities are distributed among the contributors (unit holders). Following are included in the category of managed portfolio:

- Mutual fund
- Portfolio management scheme
- Individual portfolio of an investor, managed by professionals

Performance Indicators of Managed Portfolio

The performance of a managed portfolio is measured with the help of two parameters:

1. Returns
2. Risk

1. Returns: A managed portfolio invests all funds in different securities, the benefit of which is meant for the unit-holders who contribute to the funds. NAV and its movement is the best tool to measure the performance of a managed portfolio/mutual fund. The returns generated by a mutual fund over the holding period or over a longer period can be measured in the form of percentage returns. The returns are nothing but the appreciation recorded in the NAV over a period. Returns over the holding period can be calculated as follows:

$$\text{Returns} = \frac{(\text{NAV}_t - \text{NAV}_{t-1}) + \text{Dividends}}{\text{NAV}_{t-1}} \times 100$$

NAV represents net asset value per unit; it indicates value of the assets netted against the liabilities held by a mutual fund under a particular scheme at a point of time. This represents the expected value, which might be received by the unit holders, if units are repurchased or surrendered for redemption/repurchase. NAV_t means NAV at the end, and NAV_{t-1} means NAV at the start of one year.

2. Risk: Risk of mutual fund/managed portfolio is the variability of returns over a significant period; it may be measured in the form of standard deviation of the returns. This variability indicates expected fluctuation in the returns. This risk can be classified into two types:

- Systematic Risk
- Non-systematic Risk

Systematic Risk: By systematic risk, we mean risk on account of association of a mutual fund with the general market. This risk arises on account of system-wide factors:

- Inflation Risk
- Interest rate Risk
- Political Risk
- Market Risk
- Risk due to government policies
- Natural calamities
- Scams/Malpractices
- Monsoon
- Industrial growth or output
- International events
- War-like Situation/Internal Peace

Below are some of the advantages and disadvantages of the Mutual Funds:-

Advantages of Mutual Funds:-

1. Diversification:-

Mutual funds spread their holdings across a number of different investment vehicles, which reduces the effect any single security or class of securities will have on the overall portfolio. Because mutual funds can contain hundreds or thousands of securities, investors aren't likely to be fazed if one of the securities doesn't do well.

2. Expert Management:-

Many investors lack the financial know-how to manage their own portfolio. However, non-index mutual funds are managed by professionals who dedicate their careers to helping investors receive the best risk-return trade-off according to their objectives.

3. Liquidity:-

Mutual funds, unlike some of the individual investments they may hold, can be traded daily. Though not as liquid as stocks, which can be traded intraday, buy and sell orders are filled after market close.

4. Convenience:-

If you were investing on your own, you would ideally spend time researching securities. You'd also have to purchase a huge range of securities to acquire holdings comparable to most mutual funds. Then, you'd have to monitor all those securities. Choosing a mutual fund is ideal for people who don't have the time to micromanage their portfolios.

5. Reinvestment of Income:-

Another benefit of mutual funds is that they allow you to reinvest your dividends and interest in additional fund shares. In effect, this allows you to take advantage of the opportunity to grow your portfolio without paying regular transaction fees for purchasing additional mutual fund shares.

6. Range of Investment Options and Objectives:-

There are funds for the highly aggressive investor, the risk averse, and the middle-of-the-road investor – for example, emerging markets funds, investment-grade bond funds, and balanced funds, respectively. There are also life cycle funds to ramp down risk as you near retirement. There are funds with a buy-and-hold philosophy, and others that are in and out of holdings almost daily. No matter your investing style, there's bound to be a perfect fund to match it.

7. Affordability. For as little as 500 per month, you can own shares in big Indian Company and a host of other expensive securities via mutual funds.

Disadvantages of Mutual Funds:-

1. No Control Over Portfolio:-

If you invest in a fund, you give up all control of your portfolio to the mutual fund money managers who run it.

2. Capital Gains:-

Short term capital gains are taxable. Short term capital gain is when you take out your money within 1 year in case of equity fund.

3. Fees and Expenses:-

Some mutual funds may assess a sales charge on all purchases, also known as a "load" – this is what it costs to get into the fund. Plus, all mutual funds charge annual expenses, which are conveniently expressed as an annual expense ratio – this is basically the cost of doing business. The expense ratio is expressed as a percentage, and is what you pay annually as a portion of your account value. The average for managed funds is around 1.5%. Alternatively, index funds charge much lower expenses (0.25% on average) because they are not actively managed. Since the expense ratio will eat directly into gains on an annual basis, closely compare expense ratios for different funds you're considering.

4. Over-diversification:-

Although there are many benefits of diversification, there are pitfalls of being over-diversified. Think of it like a sliding scale: The more securities you hold, the less likely you are to feel their individual returns on your overall portfolio. What this means is that though risk will be reduced, so too will the potential for gains. This may be an understood trade-off with diversification, but too much diversification can negate the reason you want market exposure in the first place.

5. Cash Drag:-

Mutual funds need to maintain assets in cash to satisfy investor redemptions and to maintain liquidity for purchases. However, investors still pay to have funds sitting in cash because annual expenses are assessed on all fund assets, regardless of whether they're invested or not.

2.1.2 Investment Strategies over an Investor's Lifetime

Assuming the basic insurance and cash reserve needs are met, individuals can start a serious investment program with their savings. Because of changes in their net worth and risk tolerance, individuals' investment strategies will change over their lifetime. In the following sections, we review various phases in the investment life cycle. Although each individual's needs and preferences are different, some general traits affect most investors over the life cycle.

The four life-cycle phases are shown in Exhibit 2.1 (the third and fourth phases—spending and gifting—are shown as concurrent) and described here.

Accumulation Phase Individuals in the early-to-middle years of their working careers are in the **accumulation phase**. As the name implies, these individuals are attempting to accumulate assets to satisfy fairly immediate needs (for example, a down payment for a house) or longer-term goals (children's college education, retirement). Typically, their net worth is small, and debt from car loans or their own past college loans may be heavy. As a result of their typically long investment time horizon and their future earning ability, individuals in the accumulation phase are willing to make relatively high-risk investments in the hopes of making above-average nominal returns over time.

Here we emphasize the wisdom of investing early and regularly in one's life. Funds invested in early life cycle phases, with returns compounding over time, will reap significant financial benefits during later phases. Exhibit 2.2 shows growth from an initial \$10,000 investment over 20, 30, and 40 years at assumed annual returns of 7 and 8 percent. The middle-aged person who invests \$10,000 "when he or she can afford it" will only reap the benefits of compounding for 20 years or so before retirement. In contrast, a person who begins saving at a younger age will reap the much higher benefits of funds invested for 30 or 40 years. Regularly investing as little as \$2,000 a year reaps large benefits over time, as well. As shown in Exhibit 2.2, a person who has invested a total of \$90,000—an initial \$10,000 investment followed by \$2,000 annual investments over 40 years—will have over half a million dollars accumulated assuming the 7 percent return. If the funds are invested more aggressively and earn the 8 percent return, the accumulation will be nearly three-quarters of a million dollars.

Exhibit 2.1 Rise and Fall of Personal Net Worth over a Lifetime

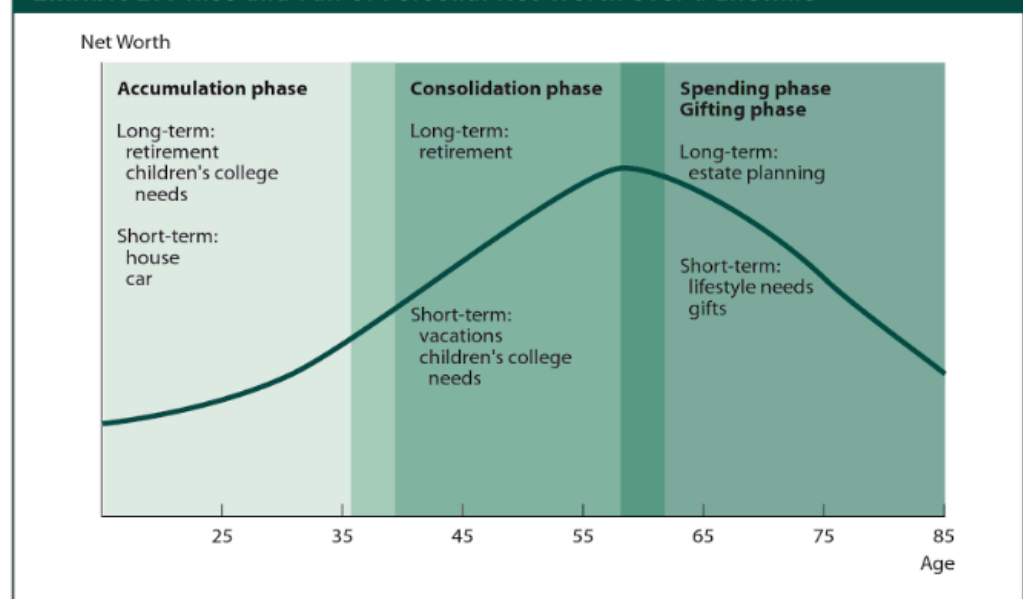


Exhibit 2.2 Benefits of Investing Early

		The Future Value of an Initial \$10,000 Investment	The Future Value of Investing \$2,000 Annually	The Future Value of the Initial Investment Plus the Annual Investment
Interest rate	7.0%			
20 years		\$38,696.84	\$81,990.98	\$120,687.83
30 years		\$76,122.55	\$188,921.57	\$265,044.12
40 years		\$149,744.58	\$399,270.22	\$549,014.80
Interest rate	8.0%			
20 years		\$46,609.57	\$91,523.93	\$138,133.50
30 years		\$100,626.57	\$226,566.42	\$327,192.99
40 years		\$217,245.21	\$518,113.04	\$735,358.25

Source: Calculations by authors.

Consolidation Phase Individuals in the **consolidation phase** are typically past the midpoint of their careers, have paid off much or all of their outstanding debts, and perhaps have paid, or have the assets to pay, their children's college bills. Earnings exceed expenses, so the excess can be invested to provide for future retirement or estate planning needs. The typical investment horizon for this phase is still long (20 to 30 years), so moderately high risk investments are attractive. At the same time, because individuals in this phase are concerned about capital preservation, they do not want to take abnormally high risks that may put their current nest egg in jeopardy.

Spending Phase The **spending phase** typically begins when individuals retire. Living expenses are covered by social security income and income from prior investments, including employer pension plans. Because their earning years have concluded (although some retirees take part-time positions or do consulting work), they are very conscious of protecting their capital. At the same time, they must balance their desire to preserve the nominal value of their savings with the need to protect themselves against a decline in the *real* value of their savings due to inflation. The average 65-year-old person in the United States has a life expectancy of about 20 years. Thus, although their overall portfolio may be less risky than in the consolidation phase, they still need some risky growth investments, such as common stocks, for inflation (purchasing power) protection.

The transition into the spending phase requires a sometimes difficult change in mindset; throughout our working life we are trying to save; suddenly we can spend. We tend to think that if we spend less, say 4 percent of our accumulated funds annually instead of 5, 6, or 7 percent, our wealth will last far longer. Although this is correct, a bear market early in our retirement can greatly reduce our accumulated funds. Fortunately, there are planning tools that can give a realistic view of what can happen to our retirement funds should markets fall early in our retirement years; this insight can assist in budgeting and planning to minimize the chance of spending (or losing) all the saved retirement funds. Annuities, which transfer risk from the individual to the annuity firm (most likely an insurance company), are another possibility. With an annuity, the recipient receives a guaranteed, lifelong stream of income. Options can allow for the annuity to continue until both a husband and wife die.

Gifting Phase The **gifting phase** is similar to, and may be concurrent with, the spending phase. In this stage, individuals may believe they have sufficient income and assets to cover their current and future expenses while maintaining a reserve for uncertainties. In such a case, excess assets can be used to provide financial assistance to relatives or friends, to establish charitable trusts, or to fund trusts as an estate planning tool to minimize estate taxes.

2.1.3 Life Cycle Investment Goals

During an individual's investment life cycle, he or she will have a variety of financial goals. **Near-term, high-priority goals** are shorter-term financial objectives that individuals set to fund purchases that are personally important to them, such as accumulating funds to make a house down payment, buy a new car, or take a trip. Parents with teenage children may have a near-term, high-priority goal to accumulate funds to help pay college expenses. Because of the emotional importance of these goals and their short time horizon, high-risk investments are not usually considered suitable for achieving them.

Long-term, high-priority goals typically include some form of financial independence, such as the ability to retire at a certain age. Because of their long-term nature, higher-risk investments can be used to help meet these objectives.

Lower-priority goals are just that—it might be nice to meet these objectives, but it is not critical. Examples include the ability to purchase a new car every few years, redecorate the home with expensive furnishings, or take a long, luxurious vacation. A well-developed policy statement considers these diverse goals over an investor's lifetime. The following sections detail the process for constructing an investment policy, creating a portfolio that is consistent with the policy and the environment, managing the portfolio, and monitoring its performance relative to its goals and objectives over time.
