

NISM

National Institute of Securities Markets

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Workbook for

**NISM – Series – V – A:
Mutual Fund Distributors Certification Examination**

Workbook
for
NISM-Series-V- A: Mutual Fund Distributors
Certification Examination



National Institute of Securities Markets

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This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Mutual Fund Distributors.

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About NISM

In pursuance of the announcement made by the Finance Minister in his Budget Speech in February 2005, Securities and Exchange Board of India (SEBI) has established the National Institute of Securities Markets (NISM) in Mumbai.

SEBI, by establishing NISM, has articulated the desire expressed by the Indian government to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM has launched an effort to deliver financial and securities education at various levels and across various segments in India and abroad. To implement its objectives, NISM has established six distinct schools to cater the educational needs of various constituencies such as investor, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

NISM is mandated to implement certification examinations for professionals employed in various segments of the Indian securities markets.

Acknowledgement

This workbook has been developed by NISM in cooperation with the Examination Committee for Mutual Fund Distributors Certification Examination consisting of representatives of Association of Mutual Funds in India (AMFI). NISM gratefully acknowledges the contribution of all committee members.

About the Author

This workbook has been developed for NISM by Mr. Sundar Sankaran, Director, Finberry Academy, and Author, *Indian Mutual Funds Handbook*.

About the Certification Examination for Mutual Fund Distributors

The examination seeks to create a common minimum knowledge benchmark for all persons involved in selling and distributing mutual funds including:

- Individual Mutual Fund Distributors
- Employees of organizations engaged in sales and distribution of Mutual Funds
- Employees of Asset Management Companies specially persons engaged in sales and distribution of Mutual Funds

The certification aims to enhance the quality of sales, distribution and related support services in the mutual fund industry.

Examination Objectives

On successful completion of the examination, the candidate should:

- Know the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features
- Understand how mutual funds are distributed in the market-place, how schemes are to be evaluated, and how suitable products and services can be recommended to investors and prospective investors in the market.
- Get oriented to the legalities, accounting, valuation and taxation aspects underlying mutual funds and their distribution.
- Get acquainted with financial planning as an approach to investing in mutual funds, and an aid for advisors to develop long term relationships with their clients.

Assessment Structure

The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score on the examination is 50%. There shall be negative marking of 25% of the marks assigned to a question.

Examination Structure

The exam covers knowledge competencies related to the basics of mutual funds and how mutual fund schemes are to be evaluated, and suitable mutual fund products and services offered to investors and prospective investors.

How to register and take the examination

To find out more and register for the examination please visit www.nism.ac.in

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1. Concept and Role of a Mutual Fund

Learning Objective

This unit seeks to introduce the concept of mutual funds, highlight the advantages they offer, and describe the salient features of various types of mutual fund schemes.

Details of how to evaluate them, and their fitment in an investor's portfolio are discussed in the second half of this Workbook

1.1 Introduction

1.1.1 Concept of Mutual Fund

Mutual funds are a vehicle to mobilize moneys from investors, to invest in different markets and securities, in line with the investment objectives agreed upon, between the mutual fund and the investors.

1.1.2 Role of Mutual Funds

Mutual funds perform different roles for different constituencies:

Their primary role is to assist investors in earning an income or building their wealth, by participating in the opportunities available in various securities and markets.

It is possible for mutual funds to structure a scheme for any kind of investment objective. Thus, the mutual fund structure, through its various schemes, makes it possible to tap a large corpus of money from diverse investors.

(Therefore, the mutual fund offers *schemes*. In the industry, the words 'fund' and 'scheme' are used inter-changeably. Various categories of schemes are called "funds". In order to ensure consistency with what is experienced in the market, this Workbook goes by the industry practice. However, wherever a difference is required to be drawn, the scheme offering entity is referred to as "mutual fund" or "the fund")

The money that is raised from investors, ultimately benefits governments, companies or other entities, directly or indirectly, to raise moneys to invest in various projects or pay for various expenses.

As a large investor, the mutual funds can keep a check on the operations of the investee company, and their corporate governance and ethical standards.

The projects that are facilitated through such financing, offer employment to people; the income they earn helps the employees buy goods and services offered by other companies, thus supporting projects of these goods and services companies. Thus, overall economic development is promoted.

The mutual fund industry itself, offers livelihood to a large number of employees of mutual funds, distributors, registrars and various other service providers.

Higher employment, income and output in the economy boost the revenue collection of the government through taxes and other means. When these are spent prudently, it promotes further economic development and nation building.

Mutual funds can also act as a market stabilizer, in countering large inflows or outflows from foreign investors. Mutual funds are therefore viewed as a key participant in the capital market of any economy.

1.1.3 Why Mutual Fund Schemes?

Mutual funds seek to mobilize money from all possible investors. Various investors have different investment preferences. In order to accommodate these preferences, mutual funds mobilize different pools of money. Each such pool of money is called a *mutual fund scheme*.

Every scheme has a pre-announced investment objective. When investors invest in a mutual fund scheme, they are effectively buying into its investment objective.

1.1.4 How do Mutual Fund Schemes Operate?

Mutual fund schemes announce their investment objective and seek investments from the public. Depending on how the scheme

is structured, it may be open to accept money from investors, either during a limited period only, or at any time.

The investment that an investor makes in a scheme is translated into a certain number of '*Units*' in the scheme. Thus, an investor in a scheme is issued units of the scheme.

Under the law, every unit has a face value of Rs10. (However, older schemes in the market may have a different face value). The face value is relevant from an accounting perspective. The number of units multiplied by its face value (Rs10) is the capital of the scheme – its *Unit Capital*.

The scheme earns interest income or dividend income on the investments it holds. Further, when it purchases and sells investments, it earns capital gains or incurs capital losses. These are called *realized capital gains* or *realized capital losses* as the case may be.

Investments owned by the scheme may be quoted in the market at higher than the cost paid. Such gains in values on securities held are called *valuation gains*. Similarly, there can be *valuation losses* when securities are quoted in the market at a price below the cost at which the scheme acquired them.

Running the scheme leads to its share of operating expenses (to be discussed in Unit 6).

Investments can be said to have been handled profitably, if the following *profitability metric* is positive:

- (A) Interest income
- (B) + Dividend income
- (C) + Realized capital gains
- (D) + Valuation gains
- (E) – Realized capital losses
- (F) – Valuation losses
- (G) – Scheme expenses

When the investment activity is profitable, the true worth of a unit goes up; when there are losses, the true worth of a unit goes down. The true worth of a unit of the scheme is otherwise called *Net Asset Value* (NAV) of the scheme. The concept of NAV is elaborated in Unit 6.

When a scheme is first made available for investment, it is called a '*New Fund Offer*' (NFO). During the NFO, investors may have the chance of buying the units at their face value. Post-NFO, when they buy into a scheme, they need to pay a price that is linked to its NAV.

The money mobilized from investors is invested by the scheme as per the investment objective committed. Profits or losses, as the case might be, belong to the investors. The investor does not however bear a loss higher than the amount invested by him.

Various investors subscribing to an investment objective might have different expectations on how the profits are to be handled. Some may like it to be paid off regularly as dividends. Others

might like the money to grow in the scheme. Mutual funds address such differential expectations between investors within a scheme, by offering various *options*, such as dividend payout option, dividend re-investment option and growth option. The implications of each of these options are discussed in Unit 7. An investor buying into a scheme gets to select the preferred option also.

The relative size of mutual fund companies is assessed by their *assets under management* (AUM). When a scheme is first launched, assets under management would be the amount mobilized from investors. Thereafter, if the scheme has a positive profitability metric, its AUM goes up; a negative profitability metric will pull it down.

Further, if the scheme is open to receiving money from investors even post-NFO, then such contributions from investors boost the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back the units of investors, the AUM falls.

The AUM thus captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.

1.1.5 Advantages of Mutual Funds for Investors

Professional Management

Mutual funds offer investors the opportunity to earn an income or build their wealth through professional management of their investible funds. There are several aspects to such professional management viz. investing in line with the investment objective,

investing based on adequate research, and ensuring that prudent investment processes are followed.

Affordable Portfolio Diversification

Units of a scheme give investors exposure to a range of securities held in the investment portfolio of the scheme. Thus, even a small investment of Rs 5,000 in a mutual fund scheme can give investors a diversified investment portfolio.

As will be seen in Unit 12, with diversification, an investor ensures that all the eggs are not in the same basket. Consequently, the investor is less likely to lose money on all the investments at the same time. Thus, diversification helps reduce the risk in investment. In order to achieve the same diversification as a mutual fund scheme, investors will need to set apart several lakh of rupees. Instead, they can achieve the diversification through an investment of a few thousand rupees in a mutual fund scheme.

Economies of Scale

The pooling of large sums of money from so many investors makes it possible for the mutual fund to engage professional managers to manage the investment. Individual investors with small amounts to invest cannot, by themselves, afford to engage such professional management.

Large investment corpus leads to various other economies of scale. For instance, costs related to investment research and office space get spread across investors. Further, the higher

transaction volume makes it possible to negotiate better terms with brokers, bankers and other service providers.

Liquidity

At times, investors in financial markets are stuck with a security for which they can't find a buyer – worse, at times they can't find the company they invested in! Such investments, whose value the investor cannot easily realise in the market, are technically called illiquid investments and may result in losses for the investor.

Investors in a mutual fund scheme can recover the value of the moneys invested, from the mutual fund itself. Depending on the structure of the mutual fund scheme, this would be possible, either at any time, or during specific intervals, or only on closure of the scheme. Schemes where the money can be recovered from the mutual fund only on closure of the scheme, are listed in a stock exchange. In such schemes, the investor can sell the units in the stock exchange to recover the prevailing value of the investment.

Tax Deferral

As will be discussed in Unit 6, mutual funds are not liable to pay tax on the income they earn. If the same income were to be earned by the investor directly, then tax may have to be paid in the same financial year.

Mutual funds offer options, whereby the investor can let the moneys grow in the scheme for several years. By selecting such options, it is possible for the investor to defer the tax liability. This

helps investors to legally build their wealth faster than would have been the case, if they were to pay tax on the income each year.

Tax benefits

Specific schemes of mutual funds (*Equity Linked Savings Schemes*) give investors the benefit of deduction of the amount invested, from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability.

Further, the dividend that the investor receives from the scheme, is tax-free in his hands. Taxation is discussed in detail in Unit 6.

Convenient Options

The options offered under a scheme allow investors to structure their investments in line with their liquidity preference and tax position.

Investment Comfort

Once an investment is made with a mutual fund, they make it convenient for the investor to make further purchases with very little documentation. This simplifies subsequent investment activity.

Regulatory Comfort

The regulator, Securities & Exchange Board of India (SEBI) has mandated strict checks and balances in the structure of mutual funds and their activities. These are detailed in the subsequent units. Mutual fund investors benefit from such protection.

Systematic approach to investments

Mutual funds also offer facilities that help investor invest amounts regularly through a *Systematic Investment Plan* (SIP); or withdraw amounts regularly through a *Systematic Withdrawal Plan* (SWP); or move moneys between different kinds of schemes through a *Systematic Transfer Plan* (STP). Such systematic approaches promote an investment discipline, which is useful in long term wealth creation and protection.

1.1.6 Limitations of a Mutual Fund

Lack of portfolio customization

Some securities houses offer Portfolio Management Schemes (PMS) to large investors. In a PMS, the investor has better control over what securities are bought and sold on his behalf.

On the other hand, a unit-holder is just one of several thousand investors in a scheme. Once a unit-holder has bought into the scheme, investment management is left to the fund manager (within the broad parameters of the investment objective). Thus, the unit-holder cannot influence what securities or investments the scheme would buy.

Large sections of investors lack the time or the knowledge to be able to make portfolio choices. Therefore, lack of portfolio customization is not a serious limitation in most cases.

Choice overload

Over 800 mutual fund schemes offered by 38 mutual funds – and multiple options within those schemes – make it difficult for investors to choose between them. Greater dissemination of industry information through various media and availability of professional advisors in the market should help investors handle this overload.

No control over costs

All the investor's moneys are pooled together in a scheme. Costs incurred for managing the scheme are shared by all the Unit-holders in proportion to their holding of Units in the scheme. Therefore, an individual investor has no control over the costs in a scheme.

SEBI has however imposed certain limits on the expenses that can be charged to any scheme. These limits, which vary with the size of assets and the nature of the scheme, are discussed in Chapter 6.

1.2 Types of Funds

This section introduces some funds to the reader. The risk aspects underlying these funds, and their suitability for different kinds of investors are discussed in later units.

1.2.1 Open-Ended Funds, Close-Ended Funds and Interval Funds

Open-ended funds are open for investors to enter or exit at any time, even after the NFO.

When existing investors buy additional units or new investors buy units of the open ended scheme, it is called a *sale transaction*. It happens at a sale price, which is equal to the NAV.

When investors choose to return any of their units to the scheme and get back their equivalent value, it is called a *re-purchase transaction*. This happens at a re-purchase price that is linked to the NAV.

Although some unit-holders may exit from the scheme, wholly or partly, the scheme continues operations with the remaining investors. The scheme does not have any kind of time frame in which it is to be closed. The ongoing entry and exit of investors implies that the unit capital in an open-ended fund would keep changing on a regular basis.

Close-ended funds have a fixed maturity. Investors can buy units of a close-ended scheme, from the fund, only during its NFO. The fund makes arrangements for the units to be traded, post-NFO in a stock exchange. This is done through a *listing* of the scheme in a stock exchange. Such listing is compulsory for close-ended schemes. Therefore, after the NFO, investors who want to buy Units will have to find a seller for those units in the stock exchange. Similarly, investors who want to sell Units will have to

find a buyer for those units in the stock exchange. Since post-NFO, sale and purchase of units happen to or from a counter-party in the stock exchange – and not to or from the mutual fund – the unit capital of the scheme remains stable.

Interval funds combine features of both open-ended and close-ended schemes. They are largely close-ended, but become open-ended at pre-specified intervals. For instance, an interval scheme might become open-ended between January 1 to 15, and July 1 to 15, each year. The benefit for investors is that, unlike in a purely close-ended scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund.

Minimum duration of an interval period in an interval scheme/plan is 15 days. No redemption/repurchase of units are allowed except during the specified transaction period (the period during which both subscription and redemption may be made to and from the scheme). The specified transaction period will be of minimum 2 working days, as per revised SEBI Regulations.

1.2.2 Actively Managed Funds and Passive Funds

Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme. Since this increases the role of the fund manager, the expenses for running the fund turn out to be higher. Investors expect actively managed funds to perform better than the market.

Passive funds invest on the basis of a specified index, whose performance it seeks to track. Thus, a passive fund tracking the BSE Sensex would buy only the shares that are part of the composition of the BSE Sensex. The proportion of each share in the scheme's portfolio would also be the same as the weightage assigned to the share in the computation of the BSE Sensex. Thus, the performance of these funds tends to mirror the concerned index. They are not designed to perform better than the market. Such schemes are also called *index schemes*. Since the portfolio is determined by the index itself, the fund manager has no role in deciding on investments. Therefore, these schemes have low running costs.

1.2.3 Debt, Equity and Hybrid Funds

A scheme might have an investment objective to invest largely in equity shares and equity-related investments like convertible debentures. Such schemes are called *equity schemes*.

Schemes with an investment objective that limits them to investments in debt securities like Treasury Bills, Government Securities, Bonds and Debentures are called *debt funds*. These debt securities are discussed in Unit 8.

Hybrid funds have an investment charter that provides for a reasonable level of investment in both debt and equity.

1.2.4 Types of Debt Funds

Gilt funds invest in only treasury bills and government securities, which do not have a credit risk (i.e. the risk that the issuer of the security defaults).

Diversified debt funds on the other hand, invest in a mix of government and non-government debt securities.

Junk bond schemes or high yield bond schemes invest in companies that are of poor credit quality. Such schemes operate on the premise that the attractive returns offered by the investee companies makes up for the losses arising out of a few companies defaulting.

Fixed maturity plans are a kind of debt fund where the investment portfolio is closely aligned to the maturity of the scheme. AMC's tend to structure the scheme around pre-identified investments. Further, like close-ended schemes, they do not accept moneys post-NFO. Thanks to these characteristics, the fund manager has little ongoing role in deciding on the investment options.

As will be seen in Unit 8, such a portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity. This helps them compare the returns with alternative investments like bank deposits.

Floating rate funds invest largely in floating rate debt securities i.e. debt securities where the interest rate payable by the issuer changes in line with the market. For example, a debt security

where interest payable is described as '5-year Government Security yield plus 1%', will pay interest rate of 7%, when the 5-year Government Security yield is 6%; if 5-year Government Security yield goes down to 3%, then only 4% interest will be payable on that debt security. The NAVs of such schemes fluctuate lesser than debt funds that invest more in debt securities offering a fixed rate of interest.

Liquid schemes or money market schemes are a variant of debt schemes that invest only in debt securities where the moneys will be repaid within 91-days. As will be seen later in this Work Book, these are widely recognized to be the lowest in risk among all kinds of mutual fund schemes.

1.2.5 Types of Equity Funds

Diversified equity fund is a category of funds that invest in a diverse mix of securities that cut across sectors.

Sector funds however invest in only a specific sector. For example, a banking sector fund will invest in only shares of banking companies. Gold sector fund will invest in only shares of gold-related companies.

Thematic funds invest in line with an investment theme. For example, an infrastructure thematic fund might invest in shares of companies that are into infrastructure construction, infrastructure toll-collection, cement, steel, telecom, power etc. The investment is thus more broad-based than a sector fund; but narrower than a diversified equity fund.

Equity Linked Savings Schemes (ELSS), as seen earlier, offer tax benefits to investors. However, the investor is expected to retain the Units for at least 3 years.

Equity Income / Dividend Yield Schemes invest in securities whose shares fluctuate less, and therefore, dividend represents a larger proportion of the returns on those shares. The NAV of such equity schemes are expected to fluctuate lesser than other categories of equity schemes.

Arbitrage Funds take contrary positions in different markets / securities, such that the risk is neutralized, but a return is earned. For instance, by buying a share in BSE, and simultaneously selling the same share in the NSE at a higher price. Most arbitrage funds take contrary positions between the equity market and the futures and options market. ('Futures' and 'Options' are commonly referred to as derivatives. These are designed to help investors to take positions or protect their risk in some other security, such as an equity share. They are traded in exchanges like the NSE and the BSE. Unit 10 provides an example of futures contract that is linked to gold).

1.2.6 Types of Hybrid Funds

Monthly Income Plan seeks to declare a dividend every month. It therefore invests largely in debt securities. However, a small percentage is invested in equity shares to improve the scheme's yield.

As will be discussed in Unit 8, the term 'Monthly Income' is a bit of a misnomer, and investor needs to study the scheme properly, before presuming that an income will be received every month.

Capital Protected Schemes are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market. This is ideally done by investing in Zero Coupon Government Securities whose maturity is aligned to the scheme's maturity. (Zero coupon securities are securities that do not pay a regular interest, but accumulate the interest, and pay it along with the principal when the security matures).

As detailed in the following example, the investment is structured, such that the principal amount invested in the zero-coupon security, together with the interest that accumulates during the period of the scheme would grow to the amount that the investor invested at the start.

Suppose an investor invested Rs 10,000 in a capital protected scheme of 5 years. If 5-year government securities yield 7% at that time, then an amount of Rs 7,129.86 invested in 5-year zero-coupon government securities would mature to Rs 10,000 in 5 years. Thus, by investing Rs 7,129.86 in the 5-year zero-coupon government security, the scheme ensures that it will have Rs 10,000 to repay to the investor in 5 years.

After investing in the government security, Rs 2,870.14 is left over (Rs 10,000 invested by the investor, less Rs 7129.86 invested in government securities). This amount is invested in riskier

securities like equities. Even if the risky investment becomes completely worthless (a rare possibility), the investor is assured of getting back the principal invested, out of the maturity moneys received on the government security.

Some of these schemes are structured with a minor difference – the investment is made in good quality debt securities issued by companies, rather than Central Government Securities. Since any borrower other than the government can default, it would be appropriate to view these alternate structures as *Capital Protection Oriented Schemes* rather than *Capital Protected Schemes*.

It may be noted that capital protection can also be offered through a guarantee from a guarantor, who has the financial strength to offer the guarantee. Such schemes are however not prevalent in the market.

1.2.7 Gold Funds

These funds invest in gold and gold-related securities. They can be structured in either of the following formats:

Gold Exchange Traded Fund, which is like an index fund that invests in gold. The structure of exchange traded funds is discussed later in this unit. The NAV of such funds moves in line with gold prices in the market.

Gold Sector Funds i.e. the fund will invest in shares of companies engaged in gold mining and processing. Though gold prices influence these shares, the prices of these shares are more closely

linked to the profitability and gold reserves of the companies. Therefore, NAV of these funds do not closely mirror gold prices.

(Gold Sector Fund is like any equity sector fund, which was discussed under 'Types of Equity Funds'. It is discussed here to highlight the difference from a Gold ETF)

1.2.8 Real Estate Funds

They take exposure to real estate. Such funds make it possible for small investors to take exposure to real estate as an asset class. Although permitted by law, real estate mutual funds are yet to hit the market in India.

1.2.9 Commodity Funds

Commodities, as an asset class, include:

- food crops like wheat and chana
- spices like pepper and turmeric
- fibres like cotton
- industrial metals like copper and aluminium
- energy products like oil and natural gas
- precious metals (bullion) like gold and silver

The investment objective of commodity funds would specify which of these commodities it proposes to invest in.

As with gold, such funds can be structured as *Commodity ETF* or *Commodity Sector Funds*. In India, mutual fund schemes are not permitted to invest in commodities. Therefore, the commodity funds in the market are in the nature of Commodity Sector Funds, i.e. funds that invest in shares of companies that are into commodities. Like Gold Sector Funds, Commodity Sector Funds too are a kind of equity fund.

1.2.10 International Funds

These are funds that invest outside the country. For instance, a mutual fund may offer a scheme to investors in India, with an investment objective to invest abroad.

One way for the fund to manage the investment is to hire the requisite people who will manage the fund. Since their salaries would add to the fixed costs of managing the fund, it can be justified only if a large corpus of funds is available for such investment.

An alternative route would be to tie up with a foreign fund (called the *host fund*). If an Indian mutual fund sees potential in China, it will tie up with a Chinese fund. In India, it will launch what is called a *feeder fund*. Investors in India will invest in the feeder *fund*. The moneys collected in the feeder fund would be invested in the Chinese host fund. Thus, when the Chinese market does well, the Chinese host fund would do well, and the feeder fund in India will follow suit.

Such feeder funds can be used for any kind of international investment. The investment could be specific to a country (like the China fund) or diversified across countries. A feeder fund can be aligned to any host fund with any investment objective in any part of the world, subject to legal restrictions of India and the other country.

In such schemes, the local investors invest in rupees for buying the Units. The rupees are converted into foreign currency for investing abroad. They need to be re-converted into rupees when the moneys are to be paid back to the local investors. Since the future foreign currency rates cannot be predicted today, there is an element of foreign currency risk.

As will be clear from Para 8.1.3 in Chapter 8, investor's total return in such schemes will depend on how the international investment performs, as well as how the foreign currency performs. Weakness in the foreign currency can pull down the investors' overall return.

1.2.11 Fund of Funds

The feeder fund was an example of a fund that invests in another fund. Similarly, funds can be structured to invest in various other funds, whether in India or abroad. Such funds are called *fund of funds*. These 'fund of funds' pre-specify the mutual funds whose schemes they will buy and / or the kind of schemes they will invest in. They are designed to help investors get over the trouble of choosing between multiple schemes and their variants in the market.

Thus, an investor invests in a fund of funds, which in turn will manage the investments in various schemes and options in the market.

1.2.12 Exchange Traded Funds

Exchange Traded funds (ETF) are open-ended index funds that are traded in a stock exchange.

A feature of open-ended funds, which allows investors to buy and sell units from the mutual fund, is made available only to very large investors in an ETF.

Other investors will have to buy and sell units of the ETF in the stock exchange. In order to facilitate such transactions in the stock market, the mutual fund appoints some intermediaries as *market makers*, whose job is to offer a price quote for buying and selling units at all times.

If more investors in the stock exchange want to buy units of the ETF, then their moneys would be due to the market maker. The market maker would use the moneys to buy a basket of securities that is in line with the investment objective of the scheme, and exchange the same for chapters of the scheme from the mutual fund. Thus, the market maker can offer the units to the investors.

If there is more selling interest in the stock exchange, then the market maker will end up with units, against which he needs to make payment to the investors. When these units are offered to the mutual fund for extinguishment, corresponding securities will be released from the investment portfolio of the scheme. Sale of

the released securities will generate the liquidity to pay the unit-holders for the units sold by them.

In a regular open-ended mutual fund, all the purchases of units by investors on a day happen at a single price. Similarly, all the sales of units by investors on a day happen at a single price. The market however keeps fluctuating during the day. A key benefit of an ETF is that investors can buy and sell their units in the stock exchange, at various prices during the day that closely track the market at that time. Further, the unique structure of ETFs, make them more cost-effective than normal index funds, although the investor would bear a brokerage cost when he transacts with the market maker.

1.3 Key Developments over the Years

The mutual fund industry in India has come a long way. Significant spurts in size were noticed in the late 80s, when public sector mutual funds were first permitted, and then in the mid-90s, when private sector mutual funds commenced operations. In the last few years, institutional distributors increased their focus on mutual funds.

The emergence of stock exchange brokers as an additional channel of distribution, the continuing growth in convenience arising out of technological developments, and higher financial literacy in the market should drive the growth of mutual funds in future.

AUM of the industry, as of February 2010 has touched Rs 766,869 crore from 832 schemes offered by 38 mutual funds. These were distributed as follows: (Source: www.amfiindia.com)

| 25 | Open-Ended | Close-Ended | Interval | Total | % |
|--|----------------|---------------|--------------|----------------|---------------|
| Income | 441,422 | 26,203 | 8,759 | 476,384 | 62.1% |
| Equity | 148,726 | 19,621 | 325 | 168,672 | 22.0% |
| Balanced | 15,277 | 1,864 | - | 17,141 | 2.2% |
| Liquid/Money Market | 73,030 | - | - | 73,030 | 9.5% |
| Gilt | 3,171 | - | - | 3,171 | 0.4% |
| ELSS – Equity | 19,617 | 3,047 | - | 22,664 | 3.0% |
| Gold ETF | 1,583 | - | - | 1,583 | 0.2% |
| OTHER ETFs | 1,342 | - | - | 1,342 | 0.2% |
| Fund Of Funds Investing Overseas | 2,882 | - | - | 2,882 | 0.4% |
| TOTAL | 707,050 | 50,735 | 9,084 | 766,869 | 100.0% |
| % | 92.2% | 6.6% | 1.2% | 100.0% | |

In some advanced countries, mutual fund AUM is a multiple of bank deposits. In India, mutual fund AUM is hardly 10% of bank deposits. This is indicative of the immense potential for growth of the industry.

The high proportion of AUM in debt, largely from institutional investors is not in line with the role of mutual funds, which is to channelize retail money into the capital market. Various regulatory measures to reduce the costs and increase the conveniences for investors are aimed at transforming mutual funds into a truly retail vehicle of capital mobilization for the larger benefit of the economy.

Multiple Choice Questions

1. The number of mutual fund schemes in India is about:
 - a. 100
 - b. 500
 - c. 800
 - d. 2000

2. Open-ended schemes generally offer exit option to investors through a stock exchange
 - a. True
 - b. False

3. Sector funds invest in a diverse range of sectors
 - a. True
 - b. False

4. High yield bond schemes invest in junk bonds
 - a. True
 - b. False

5. Investment objective is closely linked to
- a. Scheme
 - b. Option
 - c. Plan
 - d. SIP

Answers

1 – c; 2 – b, 3 – b, 4-a, 5-a

Checklist of Learning Points

- ☑ Mutual funds are a vehicle to mobilize moneys from investors, to invest in different markets and securities
- ☑ The primary role of mutual funds is to assist investors in earning an income or building their wealth, by participating in the opportunities available in the securities markets.
- ☑ In order to accommodate investor preferences, mutual funds mobilize different pools of money. Each such pool of money is called a mutual fund scheme. Mutual funds address differential expectations between investors within a scheme, by offering various options, such as dividend payout option, dividend re-investment option and growth option. An investor buying into a scheme gets to select the preferred option also.
- ☑ The investment that an investor makes in a scheme is translated into a certain number of 'Units' in the scheme. The number of units multiplied by its face value (Rs10) is the capital of the scheme – its Unit Capital.
- ☑ When the profitability metric is positive, the true worth of a unit, also called Net Asset Value (NAV) goes up.
- ☑ When a scheme is first made available for investment, it is called a 'New Fund Offer' (NFO).
- ☑ The money mobilized from investors is invested by the scheme as per the investment objective committed. Profits or losses, as the case might be, belong to the investors. The investor does not however bear a loss higher than the amount invested by him.
- ☑ The relative size of mutual fund companies is assessed by their assets under management (AUM). The AUM captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.
- ☑ Investor benefits from mutual funds include professional management, portfolio diversification, economies of scale, liquidity, tax deferral, tax benefits, convenient options, investment comfort, regulatory comfort and systematic approach to investing.

- ☑ Limitations of mutual funds are lack of portfolio customization and an overload of schemes and scheme variants.
- ☑ Open-ended funds are open for investors to enter or exit at any time and do not have a fixed maturity. Investors can acquire new units from the scheme through a *sale transaction* at their *sale price*, which is linked to the NAV of the scheme. Investors can sell their units to the scheme through a *re-purchase transaction* at their *re-purchase price*, which again is linked to the NAV.
- ☑ Close-ended funds have a fixed maturity and can be bought and sold in a stock exchange.
- ☑ Interval funds combine features of both open-ended and close-ended schemes.
- ☑ Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme.
- ☑ Passive funds invest on the basis of a specified index, whose performance it seeks to track.
- ☑ Gilt funds invest in only treasury bills and government securities
- ☑ Diversified debt funds on the other hand, invest in a mix of government and non-government debt securities
- ☑ Junk bond schemes or high yield bond schemes invest in companies that are of poor credit quality.
- ☑ Fixed maturity plans are a kind of debt fund where the investment portfolio is closely aligned to the maturity of the scheme.
- ☑ Floating rate funds invest largely in floating rate debt securities
- ☑ Liquid schemes or money market schemes are a variant of debt schemes that invest only in debt securities of less than 91-days maturity.
- ☑ Diversified equity funds invest in a diverse mix of securities that cut across sectors.
- ☑ Sector funds invest in only a specific sector.
- ☑ Thematic funds invest in line with an investment theme. The investment is more broad-based than a sector fund; but narrower than a diversified equity fund.

- ☑ Equity Linked Savings Schemes (ELSS) offer tax benefits to investors.
- ☑ Equity Income / Dividend Yield Schemes invest in shares that fluctuate less, and therefore dividends represent a significant part of the returns on those shares.
- ☑ Monthly Income Plan seeks to declare a dividend every month.
- ☑ Capital Protected Schemes are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market.
- ☑ Gold funds invest in gold and gold-related securities. They can be structured as Gold Sector Funds or ETF-Gold Schemes.
- ☑ Real estate funds invest in real estate.
- ☑ Commodity funds invest in asset classes like food crops, spices, fibres, industrial metals, energy products or precious metals as may be permitted by their investment charter.
- ☑ International funds invest abroad. They are often structured as feeder funds linked to a host fund.
- ☑ Fund of Funds invest in other funds.
- ☑ Exchange Traded Funds are open-end funds that trade in the stock exchange.
- ☑ AUM of the industry, as of February 2010 has touched Rs 766,869 crore from 832 schemes offered by 38 mutual funds.

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2. Fund Structure and Constituents

Learning Objective

In this unit, you will understand the salient features of the legal structure of mutual funds in India and the role of key constituents that make up the overall mutual fund eco-system.

Other aspects of the regulatory environment of mutual funds are covered in the next unit.

2.1 Legal Structure of Mutual Funds in India

SEBI (Mutual Fund) Regulations, 1996 as amended till date define “mutual fund” as a fund established in the form of a trust to raise moneys through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets.

Key features of a mutual fund that flow from the definition are:

- It is established as a trust
- It raises moneys through sale of units to the public or a section of the public
- The units are sold under one or more schemes

- The schemes invest in securities (including money market instruments) or gold or gold related instruments or real estate assets.

SEBI has stipulated the legal structure under which mutual funds in India need to be constituted. The structure, which has inherent checks and balances to protect the investors, can be briefly described as follows:

- Mutual funds are constituted as Trusts.
- The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund business.
- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- The operations of the mutual fund trust are governed by a Trust Deed, which is executed by the sponsors. SEBI has laid down various clauses that need to be part of the Trust Deed.
- The Trust acts through its trustees. Therefore, the role of protecting the beneficiaries (investors) is that of the Trustees. The first trustees are named in the Trust Deed, which also prescribes the procedure for change in Trustees.
- In order to perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed trustees, they are

jointly referred to as Board of Trustees. A trustee company functions through its Board of Directors.

- Day to day management of the schemes is handled by an Asset Management Company (AMC). The AMC is appointed by the sponsor or the Trustees.
- The trustees execute an investment management agreement with the AMC, setting out its responsibilities.
- Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.
- Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).

Let us understand the various agencies, by taking the example of the constitution of SBI Mutual Fund.¹

¹ The names of any market entities used in this workbook are for the purpose of illustration only. No other meaning should be construed in the choice of illustrations. NISM does not recommend any market entity or any product discussed in this workbook.

| | |
|--------------------------|--|
| Mutual Fund Trust | SBI Mutual Fund |
| Sponsor | State Bank of India |
| Trustee | SBI Mutual Fund Trustee Company Private Limited |
| AMC | SBI Funds Management Private Limited |
| Custodian | HDFC Bank Limited, Mumbai CITI BANK N.A., Mumbai Stock Holding Corporation of India Ltd., Mumbai Bank of Nova Scotia (custodian for Gold) |
| RTA | Computer Age Management Services Pvt. Ltd |

2.2 Key Constituents of a Mutual Fund

2.2.1 Sponsors

The application to SEBI for registration of a mutual fund is made by the sponsor/s. Thereafter, the sponsor invests in the capital of the AMC.

Since sponsors are the main people behind the mutual fund operation, eligibility criteria has been specified as follows:

- The sponsor should have a sound track record and reputation of fairness and integrity in all business transactions. The requirements are:
 - Sponsor should be carrying on business in financial services for 5 years
 - Sponsor should have positive net worth (share capital plus reserves minus accumulated losses) for each of those 5 years
 - Latest net worth should be more than the amount that the sponsor contributes to the capital of the AMC
 - The sponsor should have earned profits, after providing for depreciation and interest, in three of the previous five years, including the latest year.
- The sponsor should be a fit and proper person for this kind of operation.

- The sponsor needs to have a minimum 40% share holding in the capital of the AMC. Further, anyone who has more than 40% share holding in the AMC is considered to be a sponsor, and should therefore fulfil the eligibility criteria mentioned above.

In the example of SBI Mutual Fund cited above, the sponsor was an Indian public sector bank. Sponsorship may be institutional (LIC Mutual Fund), entirely foreign (like Fidelity and Franklin Templeton), predominantly foreign joint venture (like Morgan Stanley & HSBC) or predominantly Indian joint venture (like Birla Sunlife & ICICI Prudential).

2.2.2 Trustee

The trustees have a critical role in ensuring that the mutual fund complies with all the regulations, and protects the interests of the unit-holders. As part of this role, they perform various kinds of General Due Diligence and Specific Due Diligence.

The SEBI Regulations stipulate that:

- Every trustee has to be a person of ability, integrity and standing
- A person who is guilty of moral turpitude cannot be appointed trustee
- A person convicted of any economic offence or violation of any securities laws cannot be appointed as trustee

Prior approval of SEBI needs to be taken, before a person is appointed as Trustee.

The sponsor will have to appoint at least 4 trustees. If a trustee company has been appointed, then that company would need to have at least 4 directors on the Board. Further, at least two-thirds of the trustees / directors on the Board of the trustee company, would need to be *independent trustees* i.e. not associated with the sponsor in any way.

SEBI expects Trustees to perform a key role in ensuring legal compliances and protecting the interest of investors. Accordingly, various General Due Diligence and Special Due Diligence responsibilities have been assigned to them.

The strict provisions go a long way in promoting the independence of the role of trusteeship in a mutual fund.

2.2.3 AMC

Day to day operations of asset management are handled by the AMC. It therefore arranges for the requisite offices and infrastructure, engages employees, provides for the requisite software, handles advertising and sales promotion, and interacts with regulators and various service providers.

The AMC has to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of the SEBI regulations and the trust deed. Further, it has to exercise due diligence and care in all its investment decisions.

As per SEBI regulations:

- the directors of the asset management company need to be persons having adequate professional experience in finance and financial services related field
- the directors as well as key personnel of the AMC should not have been found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws
- Key personnel of the AMC should not have worked for any asset management company or mutual fund or any intermediary during the period when its registration was suspended or cancelled at any time by SEBI.

Prior approval of the trustees is required, before a person is appointed as director on the board of the AMC.

Further, at least 50% of the directors should be *independent* directors i.e. not associate of or associated with the sponsor or any of its subsidiaries or the trustees.

The AMC needs to have a minimum net worth of Rs10 crore.

An AMC cannot invest in its own schemes, unless the intention to invest is disclosed in the Offer Document. Further, the AMC cannot charge any fees for the investment.

The appointment of an AMC can be terminated by a majority of the trustees, or by 75% of the Unit-holders. However, any change in the AMC is subject to prior approval of SEBI and the Unit-holders.

Operations of AMCs are headed by a *Managing Director, Executive Director* or *Chief Executive Officer*. Some of the other business-heads are:

Chief Investment Officer (CIO), who is responsible for overall investments of the fund. Fund managers assist the CIO. As per SEBI regulations, every scheme requires a fund manager, though the same fund manager may manage multiple schemes.

Securities Analysts support the fund managers through their research inputs. As will be discussed in Unit 8, these analysts come from two streams, Fundamental Analysis and Technical Analysis. Some mutual funds also have an economist to analyse the economy.

Securities Dealers help in putting the transactions through in the market.

Chief Marketing Officer (CMO), who is responsible for mobilizing money under the various schemes. Direct Sales Team (who generally focus on large investors), Channel Managers (who manage the distributors) and Advertising & Sales Promotion Team support the CMO.

Chief Operations Officer (COO) handles all operational issues

Compliance Officer needs to ensure all the legal compliances. In Offer Documents of new issues, he signs a due-diligence certificate to the effect that all regulations have been complied with, and that all the intermediaries mentioned in the offer document have the requisite statutory registrations and approvals.

In order to ensure independence, the Compliance Officer reports directly to the head of the AMC. Further, he works closely with the Trustees on various compliance and regulatory issues.

2.3 Other Service Providers

2.3.1 Custodian

The custodian has custody of the assets of the fund. As part of this role, the custodian needs to accept and give delivery of securities for the purchase and sale transactions of the various schemes of the fund.

The Custodian is appointed by the mutual fund. A custodial agreement is entered into between the trustees and the custodian.

The SEBI regulations provide that if the sponsor or its associates control 50% or more of the shares of a custodian, or if 50% or more of the directors of a custodian represent the interest of the sponsor or its associates, then that custodian cannot be appointed for the mutual fund operation of the sponsor or its associate or subsidiary company.

An independent custodian ensures that the securities are indeed held in the scheme for the benefit of investors – an important control aspect.

The custodian also tracks corporate actions such as dividends, bonus and rights in companies where the fund has invested.

All custodians need to register with SEBI.

2.3.2 RTA

The RTA maintains investor records. Their offices in various centres serve as Investor Service Centres (ISCs), which perform a useful role in handling the documentation of investors.

The appointment of RTA is done by the AMC. It is not compulsory to appoint a RTA. The AMC can choose to handle this activity in-house.

All RTAs need to register with SEBI.

2.3.3 Auditors

Auditors are responsible for the audit of accounts.

Accounts of the schemes need to be maintained independent of the accounts of the AMC.

The auditor appointed to audit the scheme accounts needs to be different from the auditor of the AMC.

While the scheme auditor is appointed by the Trustees, the AMC auditor is appointed by the AMC.

2.3.4 Fund Accountants

The fund accountant performs the role of calculating the NAV, by collecting information about the assets and liabilities of each

scheme. The AMC can either handle this activity in-house, or engage a service provider.

2.3.5 Distributors

Distributors have a key role in selling suitable types of units to their clients i.e. the investors in the schemes.

Distributors need to pass the prescribed certification test, and register with AMFI. Regulatory aspects of their role are discussed in Unit 3, while some of the distribution and channel management practices are covered in Unit 5.

2.3.6 Collecting Bankers

The investors' moneys go into the bank account of the scheme they have invested in. These bank accounts are maintained with collection bankers who are appointed by the AMC.

Leading collection bankers make it convenient to invest in the schemes by accepting applications of investors in most of their branches. Payment instruments against applications handed over to branches of the AMC or the RTA need to be banked with the collecting bankers, so that the moneys are available for investment by the scheme.

Through this kind of a mix of constituents and specialized service providers, most mutual funds maintain high standards of service and safety for investors.

Multiple Choice Questions

1. The assets of the mutual fund are held by
 - a. AMC
 - b. Trustees
 - c. Custodian
 - d. Registrar

2. Minimum networth requirement for AMC is
 - a. Rs 10 crore
 - b. Rs 5 crore
 - c. Rs 4 crore
 - d. Rs 2 crore

3. AMC directors are appointed with the permission of Trustees
 - a. True
 - b. False

4. Most investor service centres are offices of
 - a. Trustees
 - b. Registrar

- c. Custodian
 - d. Fund Accountant
5. Fund accounting activity of a scheme is to be compulsorily outsourced
- a. True
 - b. False

Answers

1 - c, 2 - a, 3 - a, 4 - b, 5 - b

Checklist of Learning Points

- ☑ Mutual funds in India are governed by SEBI (Mutual Fund) Regulations, 1996, as amended till date.
- ☑ The regulations permit mutual funds to invest in securities including money market instruments, or gold or gold related instruments or real estate assets.
- ☑ Mutual funds are constituted as Trusts. The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund operation.
- ☑ Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- ☑ In order to perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed trustees, they are jointly referred to as Board of Trustees. A trustee company functions through its Board of Directors.
- ☑ Day to day management of the schemes is handled by an AMC. The AMC is appointed by the sponsor or the Trustees.
- ☑ Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.
- ☑ Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).
- ☑ The sponsor needs to have a minimum 40% share holding in the capital of the AMC.
- ☑ The sponsor has to appoint at least 4 trustees – atleast two-thirds of them need to be independent. Prior approval of SEBI needs to be taken, before a person is appointed as Trustee.
- ☑ AMC should have networth of at least Rs10crore. At least 50% of the directors should be independent directors. Prior approval of

the trustees is required, before a person is appointed as director on the board of the AMC.

3. Legal and Regulatory Environment

Learning Objective

The focus of this unit is on the overall regulatory environment of mutual funds in India, with a focus on the investor. Regulations related to other aspects are covered in the relevant Units across this Workbook.

3.1 Role of Regulators in India

3.1.1 SEBI

SEBI regulates mutual funds, depositories, custodians and registrars & transfer agents in the country.

The applicable guidelines for mutual funds are set out in SEBI (Mutual Funds) Regulations, 1996, as amended till date. Some aspects of these regulations are discussed in various sections of this Workbook. An updated and comprehensive list of circulars issued by SEBI can be found in the Mutual Funds section of SEBI's website www.sebi.gov.in. A useful download is a Master Circular, which captures the essence of various circulars issued upto January 1, 2010.

Some segments of the financial markets have their own independent regulatory bodies. Wherever applicable, mutual funds

need to comply with these other regulators also. For instance, RBI regulates the money market and foreign exchange market in the country. Therefore, mutual funds need to comply with RBI's regulations regarding investment in the money market, investments outside the country, investments from people other than Indians resident in India, remittances (inward and outward) of foreign currency etc.

Stock Exchanges are regulated by SEBI. Every stock exchange has its own listing, trading and margining rules. Mutual Funds need to comply with the rules of the exchanges with which they choose to have a business relationship.

Anyone who is aggrieved by a ruling of SEBI, can file an appeal with the Securities Appellate Tribunal.

3.1.2 Self Regulatory Organizations (SRO)

In the developed world, it is common for market players to create Self Regulatory Organizations, whose prime responsibility is to regulate their own members. Wherever SROs exist, the statutory regulatory bodies set up by the Government (like SEBI in India) only lay down the broad policy framework, and leave the micro-regulation to the SRO.

For instance, the Institute of Chartered Accountants of India (ICAI) regulates its own members.

Mutual Funds in India have not constituted any SRO for themselves. Therefore, they are directly regulated by SEBI.

3.1.3 AMFI Objectives

AMCs in India are members of AMFI, an industry body that has been created to promote the interests of the mutual funds industry [like Confederation of Indian Industry (CII) for overall industry and NASSCOM for the IT/BPO industry]. AMFI is not an SRO.

The objectives of AMFI are as follows:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
- To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the Mutual Fund Industry.
- To develop a cadre of well trained Agent distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.

- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on Mutual Fund Industry and to undertake studies and research directly and/or in association with other bodies.

3.1.4 AMFI Code of Ethics (ACE)

The AMFI Code of Ethics sets out the standards of good practices to be followed by the Asset Management Companies in their operations and in their dealings with investors, intermediaries and the public.

SEBI (Mutual Funds) Regulation, 1996 requires all Asset Management Companies and Trustees to abide by the Code of Conduct as specified in the Fifth Schedule to the Regulation. The AMFI Code has been drawn up to supplement that schedule, to encourage standards higher than those prescribed by the Regulations for the benefit of investors in the mutual fund industry. Appendix 1 has the details.

3.1.5 AMFI Guidelines & Norms for Intermediaries (AGNI)

AMFI has also framed a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products. The Code of Conduct is detailed in Appendix 2. SEBI has made it mandatory for intermediaries to follow the Code of Conduct.

In the event of breach of the Code of Conduct by an intermediary, the following sequence of steps is provided for:

- Write to the intermediary (enclosing copies of the complaint and other documentary evidence) and ask for an explanation within 3 weeks.
- In case explanation is not received within 3 weeks, or if the explanation is not satisfactory, AMFI will issue a warning letter indicating that any subsequent violation will result in cancellation of AMFI registration.
- If there is a proved second violation by the intermediary, the registration will be cancelled, and intimation sent to all AMCs.

The intermediary has a right of appeal to AMFI.

3.2 Investment Restrictions for Schemes

The SEBI Regulations provide for various limits to the kind of investments that are possible in mutual fund schemes, and the limits thereof. In a few cases, there are also aggregate limits for all schemes of a mutual fund together. These limits are beyond the scope of this Work Book.

However, every distributor and investor ought to know the following investment boundaries of schemes.

3.2.1 Investment Objective

This defines the broad investment charter. For example, the investment objective of a *diversified equity scheme* might read as follows:

“To generate capital appreciation from a portfolio of predominantly equity related securities”

The investment objective of a *diversified debt scheme* could be:

“To generate income by investing predominantly in a wide range of debt and money market securities”

A *balanced scheme* would have an investment objective like:

“To achieve growth by investing in equity and equity related investments, balanced with income generation by investing in debt and money market instruments”

3.2.2 Investment Policy

This describes in greater detail, the kind of portfolio that will be maintained. For example:

“The portfolio will generally comprise of equity and equity related instruments of around 30 companies, which may go upto 39 companies”; or

“Investment will be predominantly in mid-cap stocks”; or

“More than 50% will be invested in equity and equity related securities; the rest would be in debt and money market securities”

When a scheme's name implies investment in a particular kind of security or sector, it should have a policy that provides for investing at least 65% of its corpus in that security or sector, in normal times. Thus, a debt scheme would need to invest at least 65% in debt securities; an equity scheme would need to invest that much in equities; a steel sector fund would need to invest at least 65% in shares of steel companies.

3.2.3 Investment Strategy

Investment strategy goes into details such as:

- Should we increase the liquidity component in a scheme
- Should we go overweight on the steel sector

While the investment objective and investment policy are part of the offer document, investment strategy is decided more frequently. Many AMCs have a practice, where every morning, the senior management (CEO, CIO, Fund Managers) discuss the need for any change in their investment strategy.

3.3 Investors' Rights & Obligations

3.3.1 Service Standards Mandated for a Mutual Fund towards its Investors

- Schemes, other than ELSS, need to allot units or refund moneys within 5 business days of closure of the NFO.
- Open-ended schemes, other than ELSS, have to re-open for ongoing sale / re-purchase within 5 business days of allotment.
- Statement of accounts are to be sent to investors as follows:
 - In the case of NFO - within 5 business days of closure of the NFO.
 - In the case of post-NFO investment – within 10 working days of the investment
 - In the case of SIP / STP / SWP
- Initial transaction – within 10 working days
- Ongoing – once every calendar quarter (March, June, September, December) within 10 working days of the end of the quarter
 - On specific request by investor, it will be dispatched to investor within 5 working days without any cost.
 - Statement of Account shall also be sent to dormant investors i.e. investors who have not transacted during the

previous 6 months. This can be sent along with the Portfolio Statement / Annual Return, with the latest position on number and value of Units held.

- If mandated by the investor, soft copy shall be e-mailed to investor every month.
- Units of all mutual fund schemes held in demat form are freely transferable.
- Only in the case of ELSS Schemes, free transferability of units (whether demat or physical) is curtailed for the statutory minimum holding period of 3 years.
- Investor can ask for a Unit Certificate for his Unit Holding. This is different from a Statement of Account as follows:
 - A Statement of Account shows the opening balance, transactions during the period and closing balance
 - A Unit Certificate only mentions the number of Units held by the investor.
 - In a way, the Statement of Account is like a bank pass book, while the Unit Certificate is like a Balance Confirmation Certificate issued by the bank.
 - Since Unit Certificates are non-transferable, they do not offer any real transactional convenience for the Unit-holder. However, if a Unit-holder asks for it, the AMC is bound to

issue the Unit Certificate within 30 days of receipt of request.

- NAV has to be published daily, in at least 2 newspapers
- NAV and re-purchase price are to be updated in the website of AMFI and the mutual fund
 - In the case of Fund of Funds, by 10 am the following day
 - In the case of other schemes, by 9 pm the same day
- The investor/s can appoint upto 3 nominees, who will be entitled to the Units in the event of the demise of the investor/s. The investor can also specify the percentage distribution between the nominees. If no distribution is indicated, then an equal distribution between the nominees will be presumed.
- The investor can also pledge the units. This is normally done to offer security to a financier.
- Dividend warrants have to be dispatched to investors within 30 days of declaration of the dividend
- Redemption / re-purchase cheques would need to be dispatched to investors within 10 working days from the date of receipt of transaction request.
- In the event of delays in dispatching dividend warrants or redemption / repurchase cheques, the AMC has to pay the unit-holder, interest at the rate of 15% p.a. This expense has

to be borne by the AMC i.e. it cannot be charged to the scheme.

3.3.2 Other Rights of Investors

Unit-holders have proportionate right to the beneficial ownership of the assets of the scheme.

Investors can choose to change their distributor or go direct. In such cases, AMCs will need to comply, without insisting on any kind of No Objection Certificate from the existing distributor.

Investors can choose to hold the Units in dematerialised form. The mutual fund / AMC is bound to co-ordinate with the RTA and Depository to facilitate this.

In the case of unit-holding in demat form, the demat statement given by the Depository Participant would be treated as compliance with the requirement of Statement of Account.

The mutual fund has to publish a complete statement of the scheme portfolio and the unaudited financial results, within 1 month from the close of each half year. The advertisement has to appear in one National English daily, and one newspaper published in the language of the region where the head office of the mutual fund is situated.

In lieu of the advertisement, the mutual fund may choose to send the portfolio statement to all Unit-holders.

Debt-oriented, close-ended / interval, schemes /plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.

Unit-holders have the right to inspect key documents such as the Trust Deed, Investment Management Agreement, Custodial Services Agreement, R&T agent agreement and Memorandum & Articles of Association of the AMC.

SEBI has prescribed a detailed format for annual reporting on redressal of complaints received against the mutual fund (including its authorised persons, distributors, employees etc.). The report categorises different kinds of complaints. For each complaint category, the mutual fund has to report on the number of complaints, the time period in which they were resolved, and if not resolved, for how long they remain unresolved.

The trustees have to sign off on this report, which is to be disclosed in AMFI website, the website of the individual mutual fund, and its Annual Report.

Scheme-wise Annual Report, or an abridged summary has to be mailed to all unit-holders within 6 months of the close of the financial year.

The Annual Report of the AMC has to be displayed on the website of the mutual fund. The Scheme-wise Annual Report will mention that Unit-holders can ask for a copy of the AMC's Annual Report.

In the event of any issue with the AMC or scheme, the investor can first approach the investor service centre. If the issue is not

redressed, even after taking it up at senior levels in the AMC, then the investor can write to SEBI with the details.

Further, the offer document has details of the number of complaints received and their disposal. Pending investor complaints can be a ground for SEBI to refuse permission to the AMC to launch new schemes.

The trustees / AMC cannot make any change in the fundamental attributes of a scheme, unless

- i. A written communication about the proposed change is sent to each Unit-holder, and an advertisement is issued in an English daily Newspaper having nationwide circulation, and in a newspaper published in the language of the region where the head office of the mutual fund is located.
- ii. Dissenting unit-holders are given the option to exit at the prevailing Net Asset Value, without any exit load. This exit window has to be open for at least 30 days.

The appointment of the AMC for a mutual fund can be terminated by a majority of the trustees or by 75% of the Unit-holders (in practice, Unit-holding) of the Scheme.

75% of the Unit-holders (in practice, Unit-holding) can pass a resolution to wind-up a scheme.

The Trustees are bound to obtain consent of the Unit-holders:

- Whenever required to do so by SEBI, in the interest of the Unit-holders
- Whenever required to do so by 75% of the Unit-holders (in practice, Unit-holding) of the scheme
- When the trustees decide to wind-up or prematurely redeem the scheme

If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust.

The merger or consolidation of two or more schemes has so far been considered as a change in the fundamental attributes of the schemes. It has now been provided that such merger or consolidation shall not be considered a change in the fundamental attribute **of the surviving scheme** if the following conditions are met:

- a) There is no other change in the Fundamental attributes of the surviving scheme i.e. the scheme which remains in existence after the merger.
- b) Mutual Funds are able to demonstrate that the circumstances merit merger or consolidation of schemes and the interest of the unit holders of surviving scheme is not adversely affected.

3.3.3 Limitation of Rights of Unit-holders

Under the law, a trust is a notional entity. Therefore, investors cannot sue the trust (but they can file suits against trustees, as seen above).

The principle of *caveat emptor* (let the buyer beware) applies to mutual fund investments. So, the unit-holder cannot seek legal protection on the grounds of not being aware, especially when it comes to the provisions of law, and matters fairly and transparently stated in the Offer Document.

Unit-holders have a right to proceed against the AMC or trustees in certain cases. However, a proposed investor i.e. someone who has not invested in the scheme does not have the same rights.

The Companies Act, 1956 offers some protection to share-holders and people who invest in fixed deposits in companies. An investor in a scheme is however, neither a share-holder, nor a fixed deposit-holder – and the scheme is in any case not a company. Therefore, these protections under the Companies Act, 1956 are not available to investors in a scheme.

3.3.4 Unclaimed Amounts

The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market. AMC can recover investment management and advisory fees on management of these unclaimed amounts, at a maximum rate of 0.50% p.a.

Recovery of such unclaimed amounts by the investors is as follows:

- If the investor claims the money within 3 years, then payment is based on prevailing NAV i.e. after adding the income earned on the unclaimed money
- If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years

AMC is expected to make a continuous effort to remind the investors through letters to claim their dues.

The Annual Report has to mention the unclaimed amount and the number of such investors for each scheme.

3.3.5 Proceeds of Illiquid Securities

It is possible that a security was treated as wholly or partly non-recoverable at the time of maturity or winding up of a scheme. The security may subsequently yield a higher amount to the scheme. Treatment of such excess is as follows:

- If the amounts are substantial, and recovered within 2 years, then the amount is to be paid to the old investors
- In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund.

3.3.6 Investor's Obligations

PAN No. and KYC documentation are compulsory for mutual fund investments. Only exception is micro-SIPs. This is discussed in detail in Unit 7.

Investors need to give their bank account details along with the redemption request.

3.4 Can a Mutual Fund Scheme go bust?

While the AMC manages the investments of the scheme, the assets of the scheme are held by the Custodian. Both operate under the overall control of the Trustees. This system of checks and balances protects the investors from misappropriation of funds, fraud etc.

Even if some sponsors wish to move out of the business, they need to bring in some other sponsor, acceptable to SEBI, before they can exit. The new sponsor would need to put in place the entire framework of Trustees, AMC etc. Therefore, unlike the occasional experience of 'vanishing companies' in shares, mutual funds cannot vanish.

It is also pertinent to note that the custodian has custody of the investments in a scheme. As seen in Unit 2, the custodian is independent of the sponsor and the AMC. This ensures structural protection of the scheme assets for the benefit of investors.

Further, in the event of a change in sponsorship that an investor is not comfortable with, the option of exiting from the scheme with the full NAV is available for a 30-day period.

These structural requirements ensure that the investor is fully protected from most of the contingencies that can be envisaged.

3.5 Appendix 1

AMFI Code of Ethics (ACE)

1.0 INTEGRITY

- 1.1 Members and their key personnel, in the conduct of their business shall observe high standards of integrity and fairness in all dealings with investors, issuers, market intermediaries, other members and regulatory and other government authorities.
- 1.2 Mutual Fund Schemes shall be organized, operated, managed and their portfolios of securities selected, in the interest of all classes of unit holders and not in the interest of:
 - sponsors
 - directors of Members
 - members of Board of Trustees or directors of the Trustee company
 - brokers and other market intermediaries
 - associates of the Members
 - a special class selected from out of unitholders

2.0 DUE DILIGENCE

- 2.1 Members in the conduct of their Asset Management business shall at all times

- render high standards of service.
- exercise due diligence.
- exercise independent professional judgment.

2.2 Members shall have and employ effectively adequate resources and procedures which are needed for the conduct of Asset Management activities.

3.0 DISCLOSURES

3.1 Members shall ensure timely dissemination to all unitholders of adequate, accurate, and explicit information presented in a simple language about the investment objectives, investment policies, financial position and general affairs of the scheme.

3.2 Members shall disclose to unitholders investment pattern, portfolio details, ratios of expenses to net assets and total income and portfolio turnover wherever applicable in respect of schemes on annual basis.

3.3 Members shall in respect of transactions of purchase and sale of securities entered into with any of their associates or any significant unitholder

- submit to the Board of Trustees details of such transactions, justifying its fairness to the scheme.
- disclose to the unitholders details of the transaction in brief through annual and half yearly reports.

3.4 All transactions of purchase and sale of securities by key personnel who are directly involved in investment operations shall be disclosed to the compliance officer of the member at least on half yearly basis and subsequently reported to the Board of Trustees if found having conflict of interest with the transactions of the fund.

4.0 PROFESSIONAL SELLING PRACTICES

4.1 Members shall not use any unethical means to sell, market or induce any investor to buy their products and schemes

4.2 Members shall not make any exaggerated statement regarding performance of any product or scheme.

4.3 Members shall endeavour to ensure that at all times

- investors are provided with true and adequate information without any misleading or exaggerated claims to investors about their capability to render certain services or their achievements in regard to services rendered to other clients,
- investors are made aware of attendant risks in members' schemes before any investment decision is made by the investors,
- copies of prospectus, memoranda and related literature is made available to investors on request,

- adequate steps are taken for fair allotment of mutual fund units and refund of application moneys without delay and within the prescribed time limits and,
- complaints from investors are fairly and expeditiously dealt with.

4.4 Members in all their communications to investors and selling agents shall

- not present a mutual fund scheme as if it were a new share issue
- not create unrealistic expectations
- not guarantee returns except as stated in the Offer Document of the scheme approved by SEBI, and in such case, the Members shall ensure that adequate resources will be made available and maintained to meet the guaranteed returns.
- convey in clear terms the market risk and the investment risks of any scheme being offered by the Members.
- not induce investors by offering benefits which are extraneous to the scheme.
- not misrepresent either by stating information in a manner calculated to mislead or by omitting to state information which is material to making an informed investment decision.

5.0 INVESTMENT PRACTICES

- 5.1 Members shall manage all the schemes in accordance with the fundamental investment objectives and investment policies stated in the offer documents and take investment decisions solely in the interest of the unitholders.
- 5.2 Members shall not knowingly buy or sell securities for any of their schemes from or to
- any director, officer, or employee of the member
 - any trustee or any director, officer, or employee of the Trustee Company

6.0 OPERATIONS

- 6.1 Members shall avoid conflicts of interest in managing the affairs of the schemes and shall keep the interest of all unitholders paramount in all matters relating to the scheme.
- 6.2 Members or any of their directors, officers or employees shall not indulge in front running (buying or selling of any securities ahead of transaction of the fund, with access to information regarding the transaction which is not public and which is material to making an investment decision, so as to derive unfair advantage).
- 6.3 Members or any of their directors, officers or employees shall not indulge in self dealing (using their position to engage in transactions with the fund by which they benefit unfairly at the expense of the fund and the unitholders).

- 6.4 Members shall not engage in any act, practice or course of business in connection with the purchase or sale, directly or indirectly, of any security held or to be acquired by any scheme managed by the Members, and in purchase, sale and redemption of units of schemes managed by the Members, which is fraudulent, deceptive or manipulative.
- 6.5 Members shall not, in respect of any securities, be party to-
- creating a false market,
 - price rigging or manipulation
 - passing of price sensitive information to brokers, Members of stock exchanges and other players in the capital markets or take action which is unethical or unfair to investors.
- 6.6 Employees, officers and directors of the Members shall not work as agents/ brokers for selling of the schemes of the Members, except in their capacity as employees of the Member or the Trustee Company.
- 6.7 Members shall not make any change in the fundamental attributes of a scheme, without the prior approval of unitholders except when such change is consequent on changes in the regulations.
- 6.8 Members shall avoid excessive concentration of business with any broking firm, and excessive holding of units in a scheme by few persons or entities.

7.0 REPORTING PRACTICES

- 7.1 Members shall follow comparable and standardized valuation policies in accordance with the SEBI Mutual Fund Regulations.
- 7.2 Members shall follow uniform performance reporting on the basis of total return.
- 7.3 Members shall ensure scheme-wise segregation of cash and securities accounts.

8.0 UNFAIR COMPETITION

Members shall not make any statement or become privy to any act, practice or competition, which is likely to be harmful to the interests of other Members or is likely to place other Members in a disadvantageous position in relation to a market player or investors, while competing for investible funds.

9.0 OBSERVANCE OF STATUTES, RULES AND REGULATIONS

Members shall abide by the letter and spirit of the provisions of the Statutes, Rules and Regulations which may be applicable and relevant to the activities carried on by the Members.

10.0 ENFORCEMENT

Members shall:

- widely disseminate the AMFI Code to all persons and entities covered by it

- make observance of the Code a condition of employment
- make violation of the provisions of the code, a ground for revocation of contractual arrangement without redress and a cause for disciplinary action
- require that each officer and employee of the Member sign a statement that he/she has received and read a copy of the Code
- establish internal controls and compliance mechanisms, including assigning supervisory responsibility
- designate one person with primary responsibility for exercising compliance with power to fully investigate all possible violations and report to competent authority
- file regular reports to the Trustees on a half yearly and annual basis regarding observance of the Code and special reports as circumstances require
- maintain records of all activities and transactions for at least three years, which records shall be subject to review by the Trustees
- dedicate adequate resources to carrying out the provisions of the Code

11.0 DEFINITIONS

When used in this code, unless the context otherwise requires

(a) AMFI

“AMFI” means the Association of Mutual Funds in India

(b) Associate

“Associate” means and includes an ‘associate’ as defined in regulation 2(c) of SEBI (Mutual Fund) Regulations 1996.

(c) Fundamental investment policies

The “fundamental investment policies” of a scheme managed by a member means the investment objectives, policies, and terms of the scheme, that are considered fundamental attributes of the scheme and on the basis of which unitholders have invested in the scheme.

(d) Member

A “member” means the member of the Association of Mutual Funds in India.

(e) SEBI

“SEBI” means Securities and Exchange Board of India.

(f) Significant Unitholder

A "Significant Unitholder" means any entity holding 5% or more of the total corpus of any scheme managed by the member and includes all entities directly or indirectly controlled by such a unitholder.

(g) Trustee

A "trustee" means a member of the Board of Trustees or a director of the Trustee Company.

(h) Trustee Company

A "Trustee Company" is a company incorporated as a Trustee Company and set up for the purpose of managing a mutual fund.

3.6 Appendix 2

Code of Conduct for Intermediaries

as specified in

AMFI Guidelines & Norms for Intermediaries (AGNI)

- 3.1 Take necessary steps to ensure that the clients' interest is protected.
- 3.2 Adhere to SEBI Mutual Fund Regulations and guidelines issued from time to time related to selling, distribution and advertising practices. Be fully conversant with the key provisions of the Scheme Information Document (SID), Statement of Additional Information (SAI) and Key Information Memorandum (KIM) as well as the operational requirements of various schemes.
- 3.3 Provide full and latest information of schemes to investors in the form of SID, performance reports, fact sheets, portfolio disclosures and brochures and recommend schemes appropriate for the client's situation and needs.
- 3.4 Highlight risk factors of each scheme, avoid misrepresentation and exaggeration and urge investors to go through SID/KIM before deciding to make investments.
- 3.5 Disclose to the investors all material information including all the commissions (in the form of trail or any other mode) received for the different competing schemes of various Mutual Funds from

amongst which the scheme is being recommended to the investors.

- 3.6 Abstain from indicating or assuring returns in any type of scheme, unless the SID is explicit in this regard.
- 3.7 Maintain necessary infrastructure to support the AMC's in maintaining high service standards to investors and ensure that critical operations such as forwarding forms and cheques to AMC's/registrar's and despatch of statement of account and redemption cheques to investors are done within the time frame prescribed in the SID/SAI and SEBI Mutual Fund Regulations.

Note SID should be read in conjunction with SAI and not in isolation.

- 3.8 Avoid colluding with clients in faulty business practices such as bouncing cheques, wrong claiming of dividend/ redemption cheques, etc.
- 3.9 Avoid commission driven malpractices such as:
 - (a) Recommending inappropriate products solely because the intermediary is getting higher commissions therefrom.
 - (b) encouraging over transacting and churning of Mutual fund investments to earn higher commissions, even if they mean higher transaction costs and tax for investors.

- 3.10 Avoid making negative statements about any AMC or scheme and ensure that comparisons, if any, are made with similar and comparable products.
- 3.11 Ensure that all investor related statutory communications (such as changes in fundamental attributes, load, exit options and other material aspects) are sent to investors reliably and on time. Members and their key personnel, in the conduct of their business shall observe high standards of integrity and fairness in all dealings with investors, issuers, market intermediaries, other members and regulatory and other government authorities.
- 3.12 Maintain confidentiality of all investor deals and transactions.
- 3.13 When marketing various schemes, remember that a client's interest and suitability to their financial needs is paramount, and that extra commission or incentive earned should never form the basis for recommending a scheme to the client.
- 3.14 Intermediaries will not rebate commissions back to investors and avoid attracting clients through temptation of rebates / gifts etc.
- 3.15 A focus on financial planning and advisory services ensure correct selling, and also reduces the trend towards investors asking for pass back of commission.

3.16 All employees engaged in sales and marketing should obtain AMFI² Certification. Employees in other functional areas should also be encouraged to obtain the same certification.

² Since June 1, 2010 NISM-Series-V-A: Mutual Fund Distributors Certification Examination is the mandatory examination for all for all persons involved in selling and distributing mutual funds including:

- Individual Mutual Fund Distributors
- Employees of organizations engaged in sales and distribution of Mutual Funds
- Employees of Asset Management Companies specially persons engaged in sales and distribution of Mutual Funds

Multiple Choice Questions

1. SEBI regulates
 - a. Mutual Funds
 - b. Depositories
 - c. Registrar & Transfer Agents
 - d. All the above
2. Investment objective defines the broad investment charter
 - a. True
 - b. False
3. Statement of Account is to be sent to investors within ___ days of NFO closure
 - a. 3
 - b. 5
 - c. 7
 - d. 15
4. Within ___ days of dividend declaration, warrants will have to be sent to investors.

- a. 7
 - b. 10
 - c. 15
 - d. 30
5. Unit holders can hold their units in demat form
- a. True
 - b. False

Answers

1 - d, 2 - a, 3 - b, 4 - d, 5 - a

Checklist of Learning Points

- ☑ SEBI regulates mutual funds, depositories, custodians and registrars & transfer agents in the country.
- ☑ AMFI is an industry body, but not a self regulatory organization.
- ☑ The AMFI Code of Ethics sets out the standards of good practices to be followed by the Asset Management Companies in their operations and in their dealings with investors, intermediaries and the public.
- ☑ AMFI has framed AGNI, a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products.
- ☑ Investment objective defines the broad investment charter. Investment policy describes in greater detail, the kind of portfolio that will be maintained. Investment strategies are decided on a day-to-day basis by the senior management of the AMC. At least 65% of the corpus should, in the normal course, be invested in the kind of securities / sectors implied by the scheme's name.
- ☑ Statement of accounts is to be sent to investors within 5 days of closure of the NFO.
- ☑ Investor can ask for a Unit Certificate for his Unit Holding. This is different from a Statement of Account.
- ☑ NAV has to be published daily, in at least 2 newspapers
- ☑ NAV and Re-purchase Price is to be updated in the website of AMFI and the mutual fund
- ☑ The investor/s can appoint a nominee, who will be entitled to the Units in the event of the demise of the investor/s.
- ☑ The investor can also pledge the units. This is normally done to offer security to a financier.
- ☑ Dividend warrants have to be dispatched to investors within 30 days of declaration of the dividend

- ☑ Redemption / re-purchase cheques would need to be dispatched to investors within 10 working days from the date of receipt of request.
- ☑ Unit-holders have proportionate right to the beneficial ownership of the assets of the scheme.
- ☑ Investors can choose to change their distributor or go direct. In such cases, AMC's will need to comply, without insisting on No Objection Certificate from the existing distributor.
- ☑ Investors can choose to hold the Units in dematerialised form. The mutual fund / AMC is bound to co-ordinate with the RTA and Depository to facilitate this.
- ☑ In the case of unit-holding in demat form, the demat statement given by the Depository Participant would be treated as compliance with the requirement of Statement of Account.
- ☑ The mutual fund has to publish a complete statement of the scheme portfolio and the unaudited financial results, within 1 month from the close of each half year. In lieu of the advertisement, the mutual fund may choose to send the portfolio statement to all Unit-holders.
- ☑ Debt-oriented, close-ended / interval, schemes /plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.
- ☑ Scheme-wise Annual Report, or an abridged summary has to be mailed to all unit-holders within 6 months of the close of the financial year.
- ☑ The Annual Report of the AMC has to be displayed on the website of the mutual fund. The Scheme-wise Annual Report will mention that Unit-holders can ask for a copy of the AMC's Annual Report.
- ☑ The trustees / AMC cannot make any change in the fundamental attributes of a scheme, unless the requisite processes have been complied. This includes option to dissenting unit-holders to exit at the prevailing Net Asset Value, without any exit load. This exit window has to be open for at least 30 days.

- ☑ The appointment of the AMC for a mutual fund can be terminated by a majority of the trustees or by 75% of the Unit-holders (in practice, Unit-holding) of the Scheme.
- ☑ 75% of the Unit-holders (in practice, Unit-holding) can pass a resolution to wind-up a scheme
- ☑ If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust.
- ☑ Under the law, a trust is a notional entity. Therefore, investors cannot sue the trust (but they can file suits against trustees, as seen above).
- ☑ The principle of caveat emptor (let the buyer beware) applies to mutual fund investments.
- ☑ The investor can claim his moneys from the scheme within 3 years. Payment will be based on prevailing NAV. If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years
- ☑ If a security that was written off earlier is now recovered, within 2 years of closure of the scheme, and if the amounts are substantial, then the amount is to be paid to the old investors. In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund.
- ☑ PAN No. and KYC documentation is compulsory for mutual fund investments. Only exception is micro-SIPs.
- ☑ Investors need to give their bank account details along with the redemption request.
- ☑ Adequate safeguards exist to protect the investors from the possibility of a scheme going bust.

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Learning Objective

This unit will give you a good idea of what goes into a New Fund Offer and the legalities underlying the offer documents which are a key source of information for investors and prospective investors.

Specific documentation for selling and buying units, and related transactional issues are covered in Unit 7.

4.1 Offer Document – NFO, SID, SAI

4.1.1 New Fund Offer (NFO)

Units in a mutual fund scheme are offered to investors for the first time through a NFO. The following are a few key steps leading to the NFO:

- The AMC decides on a scheme to take to the market. This is decided on the basis of inputs from the CIO on investment objectives that would benefit investors, and inputs from the CMO on the interest in the market for the investment objectives.
- AMC prepares the Offer Document for the NFO. This needs to be approved by the Trustees and the BoD of the AMC

- The documents are filed with SEBI. The observations that SEBI makes on the Offer Document need to be incorporated. After approval by the trustees, the Offer Document can be issued in the market.
- The AMC decides on a suitable time-table for the issue, keeping in mind the market situation.
- The AMC launches its advertising and public relations campaigns to make investors aware of the NFO. These need to comply with SEBI's advertising code, which is discussed in Unit 5.
- The AMC holds events for intermediaries and the press to make them familiar with the scheme, its unique features, benefits for investors, etc.
- The Offer Documents and Application Forms are distributed to market intermediaries, and circulated in the market, so that investors can apply in the NFO.

Three dates are relevant for the NFO of an open-ended scheme:

NFO Open Date – This is the date from which investors can invest in the NFO

NFO Close Date – This is the date upto which investors can invest in the NFO

Scheme Re-Opening Date – This is the date from which the investors can offer their units for re-purchase to the scheme (at the

re-purchase price); or buy new units of the scheme (at the sale price). The AMC announces Sale and Re-purchase prices from the Scheme Re-Opening Date.

Close-ended Schemes have an NFO Open Date and NFO Close Date. But, they have no Scheme Re-opening Date, because the scheme does not sell or re-purchase units. Investors will need to buy or sell units from the stock exchange(s) where the scheme is listed.

Under the SEBI guidelines, NFOs other than ELSS can remain open for a maximum of 15 days. Allotment of units or refund of moneys, as the case may be, should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale / re-purchase within 5 business days of the allotment.

4.1.2 The Role of Offer Documents

Investors get to know the details of any NFO through the Offer Document. Information like the nature of the scheme, its investment objectives and term, are the core of the scheme. Such vital aspects of the scheme are referred to as its “fundamental attributes”. These cannot be changed by the AMC without going through specific legal processes, including permission of investors.

Since the disclosures in the Offer Document are as prescribed by SEBI, it is a legal document that helps investors take a balanced view on the investment. The Offer Document is one of the most important sources of information on the scheme, to help

prospective investors evaluate the merits and demerits of investing in it.

Even post-investment, the Offer Document can be referred to, to understand the investment objectives, the various commitments made by the AMC, and how well these commitments are being lived up to.

Investors need to note that their investment is governed by the principle of *caveat emptor* i.e. let the buyer beware. An investor is presumed to have read the Offer Document, even if he has not actually read it. Therefore, at a future date, the investor cannot claim that he was not aware of something, which is appropriately disclosed in the Offer Document.

Mutual Fund Offer Documents have two parts:

Scheme Information Document (SID), which has details of the scheme

Statement of Additional Information (SAI), which has statutory information about the mutual fund that is offering the scheme.

It stands to reason that a single SAI is relevant for all the schemes offered by a mutual fund.

In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID.

Both documents are prepared in the format prescribed by SEBI, and submitted to SEBI. The contents need to flow in the same

sequence as in the prescribed format. The mutual fund is permitted to add any disclosure, which it feels, is material for the investor.

Since investors are not sophisticated experts of finance or law, the documents are prepared in simple language, and in clear, concise and easy to understand style.

While SEBI does not approve or disapprove Offer Documents, it gives its observations. The mutual fund needs to incorporate these observations in the Offer Document that is offered in the market. Thus, the Offer Documents in the market are “vetted” by SEBI, though SEBI does not formally “approve” them.

4.1.3 Contents of SID

The cover page has the name of the scheme followed by its type viz.

- Open-ended / Close-ended / Interval (the scheme structure)
- Equity / Balanced / Income / Debt / Liquid / ETF (the expected nature of scheme portfolio)

It also mentions the face value of the Units being offered, relevant NFO dates (opening, closing, re-opening), date of SID, name of the mutual fund, and name & contact information of the AMC and trustee company. Finally, the cover page has the following standard clauses, which every investor ought to note:

"The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, (herein after referred to as SEBI (MF) Regulations) as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document.

The Scheme Information Document sets forth concisely the information about the scheme that a prospective investor ought to know before investing. Before investing, investors should also ascertain about any further changes to this Scheme Information Document after the date of this Document from the Mutual Fund / Investor Service Centres / Website / Distributors or Brokers.

The investors are advised to refer to the Statement of Additional Information (SAI) for details of _____ Mutual Fund, Tax and Legal issues and general information on www._____. (website address).

SAI is incorporated by reference (is legally a part of the Scheme Information Document). For a free copy of the current SAI, please contact your nearest Investor Service Centre or log on to our website.

The Scheme Information Document should be read in conjunction with the SAI and not in isolation".

- Table of Contents
- Highlights
- Introduction
 - Risk Factors
- Standard
- Scheme-specific
 - Provisions regarding minimum no. of investors in the scheme
 - Any other special considerations
 - Definitions
 - Due Diligence Certificate (issued by the AMC)
- Information about the scheme
- Units and Offer
- Fees & Expenses
- Rights of Unit-holders
- Penalties, Litigation etc.

The prescribed SID format is given in Appendix 3.

Draft SID is a public document, available for viewing in SEBI's website (www.sebi.gov.in) for 21 working days. The final SID (after incorporating SEBI's observations) has to be hosted on AMFI's website (www.amfiindia.com) two days before the issue opens.

Every mutual fund, in its website, provides for download of the SID for all its current schemes.

4.1.4 Update of SID

Regular

If a scheme is launched in the first 6 months of the financial year (say, April 2010), then the first update of the SID is due within 3 months of the end of the financial year (i.e. by June 2011).

If a scheme is launched in the second 6 months of the financial year (say, October 2010), then the first update of the SID is due within 3 months of the end of the next financial year (i.e. by June 2012).

Thereafter, SID is to be updated every year.

Need-based

In case of change in the fundamental attributes, the SID has to be updated immediately after the lapse of the time period given to existing investors to exit the scheme.

In case of any other change-

- It will be printed on a separate piece of paper (addendum) and distributed along with the SID, until the SID is updated.
- If a change is superseded by a further change (for instance, change in load), then addenda is not required for the superseded change i.e. addenda is only required to disclose the latest position.
- The change is to be advertised in an English newspaper having nation-wide circulation, and in a newspaper of the language of the region where the head office of the mutual fund is located.
- The change is to be mentioned in the website of the mutual fund.

4.1.5 Contents of SAI

- Information about Sponsors, AMC and Trustee Company (includes contact information, shareholding pattern, responsibilities, names of directors and their contact information, profiles of key personnel, and contact information of service providers {Custodian, Registrar & Transfer Agent, Statutory Auditor, Fund Accountant (if outsourced) and Collecting Bankers})
- Condensed financial information (for schemes launched in last 3 financial years)
- How to apply

- Rights of Unit-holders
- Investment Valuation Norms
- Tax, Legal & General Information (including investor grievance redressal mechanism, and data on number of complaints received and cleared, and opening and closing number of complaints for previous 3 financial years, and for the current year to-date).

Every mutual fund, in its website, provides for download of its SAI. Investors have a right to ask for a printed copy of the SAI.

Through AMFI website (www.amfiindia.com) investors can access the SAI of all the mutual funds. Examinees are advised to study the SAI for any mutual fund, to get a better understanding of the disclosures.

4.1.6 Update of SAI

Regular update is to be done by the end of 3 months of every financial year.

Material changes have to be updated on an ongoing basis and uploaded on the websites of the mutual fund and AMFI.

4.2 Key Information Memorandum

4.2.1 Role of KIM

KIM is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

4.2.2 Contents of KIM

Some of the key items are as follows:

- Name of the AMC, mutual fund, Trustee, Fund Manager and scheme
- Dates of Issue Opening, Issue Closing & Re-opening for Sale and Re-purchase
- Plans and Options under the scheme
- Risk Profile of Scheme
- Price at which Units are being issued and minimum amount / units for initial purchase, additional purchase and re-purchase
- Bench Mark
- Dividend Policy
- Performance of scheme and benchmark over last 1 year, 3 years, 5 years and since inception.
- Loads and expenses

- Contact information of Registrar for taking up investor grievances

The prescribed KIM format is in Appendix 4.

4.2.3 Update of KIM

KIM is to be updated at least once a year.

As in the case of SID, KIM is to be revised in the case of change in fundamental attributes. Other changes can be disclosed through addenda attached to the KIM.

4.3 Appendix 3:

Format of Scheme Information Document (SID)

SCHEME INFORMATION DOCUMENT

NAME OF THE SCHEME

(Type of Scheme - Open /Closed / Interval/
Equity/ Balanced/ Income/ Debt/
Liquid/ETFetc.)

Offer of Units of Rs. -- each for cash (subject to applicable load)
during the
New Fund Offer and Continuous offer for Units at NAV based
prices

New Fund Offer Opens on: _____

New Fund Offer Closes on: _____

Scheme re-opens on: _____

Name of Mutual Fund :
Name of Asset Management Company :
Name of Trustee Company :
Addresses, Website of the entities :

The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, (herein after referred to as SEBI (MF) Regulations) as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document.

The Scheme Information Document sets forth concisely the information about the scheme that a prospective investor ought to know before investing. Before investing, investors should also ascertain about any further changes to this Scheme Information Document after the date of this Document from the Mutual Fund / Investor Service Centres / Website / Distributors or Brokers.

The investors are advised to refer to the Statement of Additional Information (SAI) for details of _____ Mutual Fund, Tax and Legal issues and general information on www._____. (*website address*).

SAI is incorporated by reference (is legally a part of the Scheme Information Document). For a free copy of the current SAI, please contact your nearest Investor Service Centre or log on to our website.

The Scheme Information Document should be read in conjunction with the SAI and not in isolation.

This Scheme Information Document is dated _____.

Note:

The wording in italics is explanatory commentary/instructions.

The words in Arial font are the text to be used in the Scheme Information Document, as applicable.

Instructions:

i. A Mutual Fund is free to add any other disclosure, which in the opinion of the Trustees of the Mutual Fund (Trustees) or the Asset Management Company (AMC) is material for the investor, provided that such information is not presented in an incomplete, inaccurate or misleading manner. Care should be taken to ensure that inclusion of such information does not, by virtue of its nature, or manner of presentation, obscure or impede understanding of any information that is required to be included under the Scheme Information Document.

ii. Since investors who rely on the Scheme Information Document may not be sophisticated in legal or financial matters, care should therefore be taken to present the information in the Scheme Information Document in simple language and in a clear, concise and easily understandable manner.

iii. The scheme shall not have a name or title which may be deceptive or misleading. Scheme's name should be consistent with its statement of investment policy.

iv. The type of the scheme would mean whether the scheme is a growth scheme, income scheme, balanced scheme etc. and whether the scheme is open-ended, close-ended, an interval fund etc.

TABLE OF CONTENTS

HIGHLIGHTS/SUMMARY OF THE SCHEME - This section shall include the following:

- Investment objective
- Liquidity
- Benchmark
- Transparency/NAV Disclosure
- Loads
- Minimum Application Amount

(Highlights/summary of the scheme, irrespective of whether they appear on the Cover Page or not, shall make a specific disclosure in case of assured return schemes regarding the guarantee given either by the AMC or by the Sponsor to distribute income at the assured rate, and to redeem the capital invested, to the unit holder. This statement shall be in bold, legible fonts.)

I. INTRODUCTION

A. RISK FACTORS

Standard Risk Factors:

- Investment in Mutual Fund Units involves investment risks such as trading volumes, settlement risk, liquidity risk, default risk including the possible loss of principal.
- As the price / value / interest rates of the securities in which the scheme invests fluctuates, the value of your investment in the scheme may go up or down (Mutual Funds may also provide factors affecting capital market in general and not limited to the aforesaid)
- Past performance of the Sponsor/AMC/Mutual Fund does not guarantee future performance of the scheme.
- The name of the scheme does not in any manner indicate either the quality of the scheme or its future prospects and returns.
- The sponsor is not responsible or liable for any loss resulting from the operation of the scheme beyond the initial contribution of _____ made by it towards setting up the Fund.
- The present scheme is the first scheme being launched under its management. (Applicable, if the AMC has no previous experience in managing a Mutual Fund) • The present scheme is not a guaranteed or assured return scheme (applicable to all schemes except assured return schemes)

Scheme Specific Risk Factors

- **Schemes investing in Equities** - Describe briefly risks associated with investment in equity
- **Schemes investing in Bonds** – Describe briefly risks associated with fixed income products like Credit Risk, Prepayment Risk, Liquidity Risk etc.
- **Risks associated with Investing in Foreign Securities** - (if the scheme invests in these instruments)
- **Risks associated with Investing in Derivatives** - (if the scheme invests in these instruments)
- **Risks associated with Investing in Securitised Debt** - (if the scheme invests in these instruments)
- **Risks associated with Short Selling and Securities Lending** - (if the scheme intends to participate in short selling and securities lending).

B. REQUIREMENT OF MINIMUM INVESTORS IN THE SCHEME

(Applicability for an open-ended scheme)

The Scheme/Plan shall have a minimum of 20 investors and no single investor shall account for more than 25% of the corpus of

the Scheme/Plan(s). However, if such limit is breached during the NFO of the Scheme, the Fund will endeavour to ensure that within a period of three months or the end of the succeeding calendar quarter from the close of the NFO of the Scheme, whichever is earlier, the Scheme complies with these two conditions. In case the Scheme / Plan(s) does not have a minimum of 20 investors in the stipulated period, the provisions of Regulation 39(2)(c) of the SEBI (MF) Regulations would become applicable automatically without any reference from SEBI and accordingly the Scheme / Plan(s) shall be wound up and the units would be redeemed at applicable NAV. The two conditions mentioned above shall also be complied within each subsequent calendar quarter thereafter, on an average basis, as specified by SEBI. If there is a breach of the 25% limit by any investor over the quarter, a rebalancing period of one month would be allowed and thereafter the investor who is in breach of the rule shall be given 15 days notice to redeem his exposure over the 25 % limit. Failure on the part of the said investor to redeem his exposure over the 25 % limit within the aforesaid 15 days would lead to automatic redemption by the Mutual Fund on the applicable Net Asset Value on the 15th day of the notice period. The Fund shall adhere to the requirements prescribed by SEBI from time to time in this regard.

(Applicability for a Close ended scheme / Interval scheme)

The Scheme(s) and individual Plan(s) under the Scheme(s) shall have a minimum of 20 investors and no single investor shall account for more than 25% of the corpus of the

Scheme(s)/Plan(s). These conditions will be complied with immediately after the close of the NFO itself i.e. at the time of allotment. In case of non-fulfilment with the condition of minimum 20 investors, the Scheme(s)/Plan(s) shall be wound up in accordance with Regulation 39 (2) (c) of SEBI (MF) Regulations automatically without any reference from SEBI. In case of non-fulfilment with the condition of 25% holding by a single investor on the date of allotment, the application to the extent of exposure in excess of the stipulated 25% limit would be liable to be rejected and the allotment would be effective only to the extent of 25% of the corpus collected. Consequently, such exposure over 25% limits will lead to refund within 6 weeks of the date of closure of the New Fund Offer.

For interval scheme the aforesaid provision will be applicable at the end of NFO and specified transaction period.

C. SPECIAL CONSIDERATIONS, if any

D. DEFINITIONS - All terms used in the Scheme Information Document shall be defined in this Section.

Instructions:

i. Language and terminology used in the Scheme Information Document shall be as provided in the Regulations. Any new term if used shall be clearly defined.

ii. All terms shall be used uniformly throughout the text of the Scheme Information Document e.g. the terms 'sale price' and

'repurchase price' shall be used uniformly to indicate 'offer price' and 'bid price' of units.

iii. The term 'scheme' shall be used uniformly to indicate the different schemes of a Mutual Fund.

E. DUE DILIGENCE BY THE ASSET MANAGEMENT COMPANY

The Asset Management Company shall confirm that a Due Diligence Certificate duly signed by the Compliance Officer / Chief Executive Officer / Managing Director / Whole time Director/ Executive Director of the Asset Management Company has been submitted to SEBI, which reads as follows:

It is confirmed that:

(i) the draft Scheme Information Document forwarded to SEBI is in accordance with the SEBI (Mutual Funds) Regulations, 1996 and the guidelines and directives issued by SEBI from time to time.

(ii) all legal requirements connected with the launching of the scheme as also the guidelines, instructions, etc., issued by the Government and any other competent authority in this behalf, have been duly complied with.

(iii) the disclosures made in the Scheme Information Document are true, fair and adequate to enable the investors to make a well informed decision regarding investment in the proposed scheme.

(iv) the intermediaries named in the Scheme Information Document and Statement of Additional Information are registered with SEBI and their registration is valid, as on date.

II. INFORMATION ABOUT THE SCHEME

A. TYPE OF THE SCHEME - (open/close/interval, Equity/Debt/Income/Liquid/Balanced/ETF etc.)

B. WHAT IS THE INVESTMENT OBJECTIVE OF THE SCHEME?

The scheme's investment objective and policies (including the types of securities in which it will invest) shall be clearly and concisely stated in the Scheme Information Document so that they may be readily understood by the unit holder/investor.

C. HOW WILL THE SCHEME ALLOCATE ITS ASSETS?

This includes asset allocation table giving the broad classification of assets and indicative exposure level in percentage terms specifying the risk profile. If the scheme's name implies that it will invest primarily in a particular type of security, or in a certain industry or industries, the scheme shall have an investment policy that requires that, under normal circumstances, at least 65 percent of the value of its total assets be invested in the indicated type of security or industry. The asset allocation should be consistent with the investment objective of the scheme.

| Instruments | Indicative allocations (% of total assets) | | Risk Profile |
|-------------|---|---------|-----------------|
| | Maximum | Minimum | High/Medium/Low |
| | | | |

Percentage of investment in foreign securities, derivatives, stock lending, securitized debt etc. to be indicated.

D.WHERE WILL THE SCHEME INVEST?

This includes a brief narration on the types of instruments in which the scheme will invest and the concerned regulations and limits applicable shall also be mentioned.

Investment in overseas securities shall be made in accordance with the requirements stipulated by SEBI and RBI from time to time.

Brief narration on the various derivative products specifying (i) the instruments to be used (ii) the applicable limits.

E.WHAT ARE THE INVESTMENT STRATEGIES?

Information about investment approach and risk control should be included in simple terms. In case the scheme proposes to invest in derivatives, disclosures on the various strategies to be adopted by the fund manager shall be made.

In case of assured return schemes, the Scheme Information Document shall disclose:

- 1. how many schemes have assured returns, their number and corpus size;*
- 2. the justification as to how the net worth and liquidity position of the guarantor would be adequate to meet the shortfall in these schemes;*
- 3. details of the schemes which did not pay assured returns in the past and how the shortfall was met.*

Further, Portfolio turnover policy, particularly for equity oriented schemes shall also be disclosed. In discussing the investment strategies, the scheme shall briefly discuss in the Scheme Information Document the probable effect of such strategies on the rate of the total portfolio turnover of the scheme, if such effects are significant and also other consequences which will result from the higher portfolio turnover rate e.g. higher brokerage and transaction cost.

F: FUNDAMENTAL ATTRIBUTES

Following are the Fundamental Attributes of the scheme, in terms of Regulation 18 (15A) of the SEBI (MF) Regulations:

(i) Type of a scheme

- o Open ended/Close ended/Interval scheme
- o Sectoral Fund/Equity Fund/Balance Fund/Income Fund/Index Fund/Any other type of Fund

(ii) Investment Objective

- o Main Objective - Growth/Income/Both.
- o Investment pattern - The tentative Equity/Debt/Money Market portfolio break-up with minimum and maximum asset allocation, while retaining the option to alter the asset allocation for a short term period on defensive considerations.

(iii) Terms of Issue

- o Liquidity provisions such as listing, repurchase, redemption.
- o Aggregate fees and expenses charged to the scheme.
- o Any safety net or guarantee provided.

In accordance with Regulation 18(15A) of the SEBI (MF) Regulations, the Trustees shall ensure that no change in the fundamental attributes of the Scheme(s) and the Plan(s) / Option(s) thereunder or the trust or fee and expenses payable or any other change which would modify the Scheme(s) and the

Plan(s) / Option(s) thereunder and affect the interests of Unitholders is carried out unless:

- A written communication about the proposed change is sent to each Unitholder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the Mutual Fund is situated; and
- The Unitholders are given an option for a period of 30 days to exit at the prevailing Net Asset Value without any exit load.

Instruction

It shall be ensured that the advertisement is published and written communication is dispatched appropriately in advance of the commencement of 30 days period.

G. HOW WILL THE SCHEME BENCHMARK ITS PERFORMANCE ?

The name and the justification (specific to the scheme objective) for the use of benchmark index with which the performance of the scheme can be compared with.

H. WHO MANAGES THE SCHEME?

Name, age, qualification and experience of the fund manager to the scheme to be disclosed. The experience of the fund manager

should include last 10 years experience and also the name of other schemes under his /her management.

I. WHAT ARE THE INVESTMENT RESTRICTIONS?

All the investment restrictions as contained in the Seventh Schedule to SEBI (Mutual Funds) Regulations, 1996 and applicable to the scheme should be incorporated. Further in case the fund follows any internal norms vis-à-vis limiting exposure to a particular scrip or sector, etc. apart from the aforementioned investment restrictions the same needs to be disclosed.

In case of equity schemes disclose only equity related investment restriction though the scheme would be investing a portion of the assets in bonds for liquidity or for other purposes. In case of fixed income/debt schemes disclose only the investment restriction applicable to bonds. In case of balanced schemes all investment restrictions are to be disclosed.

J. HOW HAS THE SCHEME PERFORMED?

| <p><i>[In case of a new scheme, this is not applicable hence give the statement- "This scheme is a new scheme and does not have any performance track record"]</i></p> <p><i>Or</i></p> <p><i>[In case of a scheme in existence, the return figures shall be given for that scheme only, as per the For a scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised Returns and for scheme which is in existence for less than 1 year, the returns would be absolute returns since inception.</i></p> <p><i>Absolute returns for each financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.]</i></p> | Compounded Annualised Returns | Scheme Returns % | Benchmark Returns % | | | | | | | | | | | | | | | | | | |
|--|-------------------------------|---------------------|---------------------|----------------|------------------|---------------------|-----|----|----|-----|----|----|-----|----|----|-----|----|----|-----|----|----|
| | Returns for the last 1 year | | | | | | | | | | | | | | | | | | | | |
| | Returns for the last 3 years | | | | | | | | | | | | | | | | | | | | |
| | Returns for the last 5 years | | | | | | | | | | | | | | | | | | | | |
| | Returns since inception | | | | | | | | | | | | | | | | | | | | |
| <p>Absolute Returns for each financial year for the last 5 years</p> <table border="1"> <caption>Data for Absolute Returns for each financial year for the last 5 years</caption> <thead> <tr> <th>Financial Year</th> <th>Scheme Returns %</th> <th>Benchmark Returns %</th> </tr> </thead> <tbody> <tr> <td>a-b</td> <td>18</td> <td>18</td> </tr> <tr> <td>b-c</td> <td>18</td> <td>18</td> </tr> <tr> <td>c-d</td> <td>18</td> <td>18</td> </tr> <tr> <td>d-e</td> <td>18</td> <td>18</td> </tr> <tr> <td>e-f</td> <td>18</td> <td>18</td> </tr> </tbody> </table> | | | | Financial Year | Scheme Returns % | Benchmark Returns % | a-b | 18 | 18 | b-c | 18 | 18 | c-d | 18 | 18 | d-e | 18 | 18 | e-f | 18 | 18 |
| Financial Year | Scheme Returns % | Benchmark Returns % | | | | | | | | | | | | | | | | | | | |
| a-b | 18 | 18 | | | | | | | | | | | | | | | | | | | |
| b-c | 18 | 18 | | | | | | | | | | | | | | | | | | | |
| c-d | 18 | 18 | | | | | | | | | | | | | | | | | | | |
| d-e | 18 | 18 | | | | | | | | | | | | | | | | | | | |
| e-f | 18 | 18 | | | | | | | | | | | | | | | | | | | |

III. UNITS AND OFFER

This section provides details you need to know for investing in the scheme.

IV. FEES AND EXPENSES

This section outlines the expenses that will be charged to the schemes.

A. NEW FUND OFFER (NFO)

| | |
|---|--|
| <p>New Fund Offer Period This is the period during which a new scheme sells its units to the investors.</p> | <p>NFO opens on: NFO closes on: <i>(mention provision, if any, for extension and/or early closure)</i></p> |
| <p>New Fund Offer Price: This is the price per unit that the investors have to pay to invest during the NFO.</p> | |
| <p>Minimum Amount for Application in the NFO</p> | |
| <p>Minimum Target amount This is the minimum amount required to operate the scheme and if this is not collected during the NFO period, then all the investors would be refunded the amount invested without any return. However, if AMC fails to refund the amount within 6 weeks, interest as specified by SEBI (currently 15% p.a.) will be paid to the investors from the expiry of six weeks from the date of closure of the subscription period.</p> | <p>Rs. _____</p> |
| <p>Maximum Amount to be raised (if any) This is the maximum amount which can be collected during the NFO period, as decided by the AMC.</p> | <p>Rs. _____</p> |
| <p>Plans / Options offered</p> | <p>Dividend, Growth, Bonus etc.</p> |

| | |
|--|--|
| Dividend Policy | |
| Allotment | <i>Mention, the procedure for allotment and dispatch of account statements/unit certificates. Indicate the time period.</i> |
| Refund | If application is rejected, full amount will be refunded within 6 weeks of closure of NFO. If refunded later than 6 weeks, interest @ 15% p.a. for delay period will be paid and charged to the AMC. |
| Who can invest This is an indicative list and you are requested to consult your financial advisor to ascertain whether the scheme is suitable to your risk profile. | <i>Mention category of applicants, who are eligible to invest in the scheme. The AMC may also want to mention if there are any specific categories who are prohibited from investing in the scheme.</i> |
| Where can you submit the filled up applications. | <i>Provide name, address and contact no. of Registrar and Transfer Agent (R&T), email id of R&T, website address of R&T, official points of acceptance, collecting banker details etc. on back cover page.</i> |

| | |
|--|--|
| How to Apply | Please refer to the SAI and Application form for the instructions. |
| Listing | <i>Mention, if applicable, the name of the Stock Exchange and the time frame by which the listing will be done.</i> |
| Special Products / facilities available during the NFO | <i>Briefly describe the facilities/products available. Facilities like: Systematic Investment Plan Systematic Transfer Plan Systematic Withdrawal Plan</i> |
| The policy regarding reissue of repurchased units, including the maximum extent, the manner of reissue, the entity (the scheme or the AMC) involved in the same. | |
| Restrictions, if any, on the right to freely retain or dispose of units being offered. | |

B. ONGOING OFFER DETAILS

| | |
|--|---|
| <p>Ongoing Offer Period</p> <p>This is the date from which the scheme will reopen for subscriptions/redemptions after the closure of the NFO period.</p> | <p>W.e.f ____ (date) or within ____ days of the date of Closure of the NFO.</p> |
| <p>Ongoing price for subscription/purchase)/ switch-in (from other schemes/plans of the mutual fund) by investors.</p> <p>This is the price you need to pay for purchase/switch-in.</p> <p><i>Example: If the applicable NAV is Rs. 10, entry load is 2% then sales price will be: Rs. 10* (1+0.02) = Rs. 10.20</i></p> | <p>At the applicable NAV subject to prevailing entry load</p> |

| | |
|--|--|
| <p>Ongoing price for redemption (sale) /switch outs (to other schemes / plans of the Mutual Fund) by investors.</p> <p>This is the price you will receive for redemptions / switch outs.</p> <p><i>Example: If the applicable NAV is Rs. 10, exit load is 2% then redemption price will be: Rs. 10* (1-0.02) = Rs. 9.80</i></p> | <p>At the applicable NAV subject to prevailing exit load.</p> |
| <p>Cut off timing for subscriptions / redemptions / switches</p> <p>This is the time before which your application (complete in all respects) should reach the official points of acceptance.</p> | |
| <p>Where can the applications for purchase/redemption switches be submitted?</p> | <p><i>Provide the details of official points of acceptance, collecting banker details etc. on back cover page.</i></p> |
| <p>Minimum amount for purchase / redemption / switches</p> | |
| <p>Minimum balance to be maintained and consequences of non maintenance.</p> | |

| | |
|----------------------------|--|
| Special Products available | <i>Systematic Investment Plan</i> <i>Systematic Transfer Plan</i> <i>Systematic Withdrawal Plan</i> |
| Accounts Statements | <p>For normal transactions (other than SIP/STP) during ongoing sales and repurchase:</p> <p>The AMC shall issue to the investor whose application (other than SIP/STP) has been accepted, an account statement specifying the number of units allotted (state the service standard for the same)</p> <p>For those unitholders who have provided an e-mail address, the AMC will send the account statement by e-mail.</p> <p>The unitholder may request for a physical account statement by writing/calling the AMC/ISC/R&T. (state procedure).</p> |

| | |
|----------------------------|--|
| <p>Accounts Statements</p> | <p>For SIP / STP transactions:</p> <p>Account Statement for SIP and STP will be despatched once every quarter ending March, June, September and December within 10 working days of the end of the respective quarter.</p> <p>A soft copy of the Account Statement shall be mailed to the investors under SIP/STP to their e-mail address on a monthly basis, if so mandated.</p> <p>However, the first Account Statement under SIP/STP shall be issued within 10 working days of the initial investment/transfer.</p> <p>In case of specific request received from investors, Mutual Funds shall provide the account statement (SIP/STP) to the investors within 5 working days from the receipt of such request without any charges.</p> |
|----------------------------|--|

| | |
|--|--|
| Accounts Statements | <p>Annual Account Statement:</p> <p>The Mutual Funds shall provide the Account Statement to the Unitholders who have not transacted during the last six months prior to the date of generation of account statements. The Account Statement shall reflect the latest closing balance and value of the Units prior to the date of generation of the account statement.</p> <p>The account statements in such cases may be generated and issued along with the Portfolio Statement or Annual Report of the Scheme.</p> <p>Alternately, soft copy of the account statements shall be mailed to the investors' e-mail address, instead of physical statement, if so mandated.</p> |
| Dividend | The dividend warrants shall be dispatched to the unitholders within 30 days of the date of declaration of the dividend. |
| Redemption | The redemption or repurchase proceeds shall be dispatched to the unitholders within 10 working days from the date of redemption or repurchase. |
| Delay in payment of redemption / repurchase proceeds | The Asset Management Company shall be liable to pay interest to the unitholders at such rate as may be specified by SEBI for the period of such delay (presently @ 15% per annum). |

C. PERIODIC DISCLOSURES

| | |
|--|--|
| <p>Net Asset Value</p> <p>This is the value per unit of the scheme on a particular day. You can ascertain the value of your investments by multiplying the NAV with your unit balance.</p> | <p>The Mutual Fund shall declare the Net asset value of the scheme on every business day on AMFI's website www.amfiindia.com by <i>(time limit for uploading NAV as per applicable guidelines)</i> and also on their website.</p> <p><i>In case of open ended schemes, the NAV shall be calculated for all business days and released to the Press. In case of closed ended schemes, the NAV shall be calculated at least once a week (on Wednesday) and released to the Press.</i></p> <p><i>In case of Fund of Fund and investments in foreign securities, the applicable NAV disclosure policy may be indicated.</i></p> |
| <p>Half yearly Disclosures: Portfolio / Financial Results</p> <p>This is a list of securities where the corpus of the scheme is currently invested. The market value of these investments is also stated in portfolio disclosures.</p> | <p><i>The mutual fund shall publish a complete statement of the scheme portfolio and the unaudited financial results, within one month from the close of each half year (i.e. 31st March and 30th September), by way of an advertisement at least, in one National English daily and one regional newspaper in the language of the region where the head office of the mutual fund is located.</i></p> <p><i>The mutual fund may opt to send</i></p> |

| | | | |
|---|--|---------------------------|--------------------|
| | <i>the portfolio to all unit holders in lieu of the advertisement (if applicable).</i> | | |
| Half Yearly Results | <i>The mutual fund and Asset Management Company shall before the expiry of one month from the close of each half year that is on 31st March and on 30th September, publish its unaudited financial results in one national English daily newspaper and in a regional newspaper published in the language of the region where the Head Office of the mutual fund is situated.</i> | | |
| Annual Report | <i>Scheme wise Annual Report or an abridged summary thereof shall be mailed to all unitholders within six months from the date of closure of the relevant accounts year i.e. 31st March each year.</i> | | |
| Associate Transactions | Please refer to Statement of Additional Information (SAI). | | |
| Taxation The information is provided for general information only. However, in view of the individual nature of the implications, each investor is advised to consult his or her own tax advisors / authorized dealers with respect to the specific amount of tax and other implications arising out of | | | |
| | | Resident Investors | Mutual Fund |
| | <u>Equity Fund</u> Tax on Dividend | | |

| | | | |
|--|---|--|--|
| his or her participation in the schemes. (mention the tax rates as per the applicable tax laws) | Capital Gains: | | |
| | Long Term | | |
| | Short Term | | |
| | Equity scheme will also attract securities transaction tax (STT) at applicable rates. | | |
| | For further details on taxation please refer to the clause on Taxation in the SAI | | |
| Investor services | <i>Name, address and telephone number and e-mail of the contact person/grievances officer who would take care of investor queries and complaints.</i> | | |

D. COMPUTATION OF NAV

Describe briefly the policies of the Mutual Fund with regard computation of NAV of the scheme in accordance with SEBI (Mutual Funds) Regulations, 1996.

Rounding off policy for NAV as per the applicable guidelines shall be disclosed.

Policy on computation of NAV in case of investment in foreign securities shall be disclosed.

IV. FEES AND EXPENSES

This section outlines the expenses that will be charged to the schemes.

A. NEW FUND OFFER (NFO) EXPENSES

These expenses are incurred for the purpose of various activities related to the NFO like sales and distribution fees paid marketing and advertising, registrar expenses, printing and stationary, bank charges etc. *Details of source for meeting these expenses may be disclosed.*

B. ANNUAL SCHEME RECURRING EXPENSES

These are the fees and expenses for operating the scheme. These expenses include Investment Management and Advisory Fee charged by the AMC, Registrar and Transfer Agents' fee, marketing and selling costs etc. as given in the table below:

The AMC has estimated that upto ____ % of the weekly average net assets of the scheme will be charged to the scheme as expenses (*Give slab wise break up depending on the assets under management. Give plan/option wise break up if the expense structures are different*). For the actual current expenses being charged, the investor should refer to the website of the mutual fund.

| Particulars | % of Net Assets | |
|---|---|--|
| | <i>Retail Plan (the name of the plan as applicable)</i> | <i>Institutional Plan (the name of the plan as applicable)</i> |
| Investment Management & Advisory Fee | | |
| Custodial Fees | | |
| Registrar & Transfer Agent Fees including cost related to providing accounts statement, dividend/redemption cheques/warrants etc. | | |
| Marketing & Selling Expenses including Agents Commission and statutory advertisement | | |
| Brokerage & Transaction Cost pertaining to the distribution of units | | |

| | | |
|--|--|--|
| Audit Fees / Fees and expenses of trustees | | |
| Costs related to investor communications | | |
| Costs of fund transfer from location to location | | |
| Other Expenses* | | |
| Total Recurring Expenses | | |

(To be specified as permitted under the Regulation 52 of SEBI (MF) Regulations)*

These estimates have been made in good faith as per the information available to the Investment Manager based on past experience and are subject to change inter-se. Types of expenses charged shall be as per the SEBI (MF) Regulations. *(The regulatory limits on Annual Recurring Expenses and Investment Management & Advisory fees in terms of Regulation 52 shall be disclosed).*

The mutual fund would update the current expense ratios on the website within two working days mentioning the effective date of the change.

C. LOAD STRUCTURE

Load is an amount which is paid by the investor to subscribe to the units or to redeem the units from the scheme. This amount is used by the AMC to pay commissions to the distributor and to take care of other marketing and selling expenses. Load amounts are variable and are subject to change from time to time. For the current applicable structure, please refer to the website of the AMC (www.-----) or may call at (toll free no.) or your distributor.

| Type of Load | Load chargeable (as %age of NAV) |
|--------------|----------------------------------|
| Entry | |
| Exit * | |
| | |

** The load on other types of transaction could be Dividend Reinvestment, Switch in/out, SIP/SWP/STP (which shall be disclosed in the table above as applicable)*

Load exemptions, if any: (e.g. Fund of Funds)

Bonus units and units issued on reinvestment of dividends shall not be subject to entry and exit load.

All loads including Contingent Deferred Sales Charge (CDSC) for the Scheme shall be maintained in a separate account and may be utilised towards meeting the selling and distribution expenses. Any surplus in this account may be credited to the scheme, whenever felt appropriate by the AMC.

The investor is requested to check the prevailing load structure of the scheme before investing.

For any change in load structure AMC will issue an addendum and display it on the website/Investor Service Centres.

Note: Wherever quantitative discounts are involved the following shall be disclosed – The Mutual Fund may charge the load within the stipulated limit of 7% and without any discrimination to any specific group of unit holders. However, any change at a later stage shall not affect the existing unit holders adversely.

D. WAIVER OF LOAD FOR DIRECT APPLICATIONS

Disclose detailed procedure for direct applications as per the applicable SEBI guidelines in order to provide the waiver of load to the investors.

V. RIGHTS OF UNITHOLDERS

Please refer to SAI for details.

VI. PENALTIES, PENDING LITIGATION OR PROCEEDINGS, FINDINGS OF INSPECTIONS OR INVESTIGATIONS FOR WHICH ACTION MAY HAVE BEEN TAKEN OR IS IN THE PROCESS OF BEING TAKEN BY ANY REGULATORY AUTHORITY

This section shall contain the details of penalties, pending litigation, and action taken by SEBI and other regulatory and Govt. Agencies.

- 1. All disclosures regarding penalties and action(s) taken against foreign Sponsor(s) may be limited to the jurisdiction of the country where the principal activities (in terms of income / revenue) of the Sponsor(s) are carried out or where the headquarters of the Sponsor(s) is situated. Further, only top 10 monetary penalties during the last three years shall be disclosed.*
- 2. In case of Indian Sponsor(s), details of all monetary penalties imposed and/ or action taken during the last three years or pending with any financial regulatory body or governmental authority, against Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company; for irregularities or for violations in the financial services sector, or for defaults with respect to share holders or debenture holders and depositors, or for economic offences, or for violation of securities law. Details of settlement, if any, arrived at with the aforesaid authorities during the last three years shall also be disclosed.*
- 3. Details of all enforcement actions taken by SEBI in the last three years and/ or pending with SEBI for the violation of SEBI Act, 1992 and Rules and Regulations framed there under including*

debarment and/ or suspension and/ or cancellation and/ or imposition of monetary penalty/adjudication/enquiry proceedings, if any, to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel (especially the fund managers) of the AMC and Trustee Company were/ are a party. The details of the violation shall also be disclosed.

4. Any pending material civil or criminal litigation incidental to the business of the Mutual Fund to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel are a party should also be disclosed separately.

5. Any deficiency in the systems and operations of the Sponsor(s) and/ or the AMC and/ or the Board of Trustees/Trustee Company which SEBI has specifically advised to be disclosed in the SID, or which has been notified by any other regulatory agency, shall be disclosed.

Notwithstanding anything contained in this Scheme Information Document, the provisions of the SEBI (Mutual Funds) Regulations, 1996 and the guidelines there under shall be applicable.

4.4 Appendix 4

Name of AMC & MF

(Type of scheme)

KEY INFORMATION MEMORANDUM

----- Scheme

(-----)

Offer for Units of Rs. -- Per Unit for cash during the
New fund Offer Period and at NAV based prices upon re-
opening

New Fund Offer Opens on:

New Fund Offer Closes on:

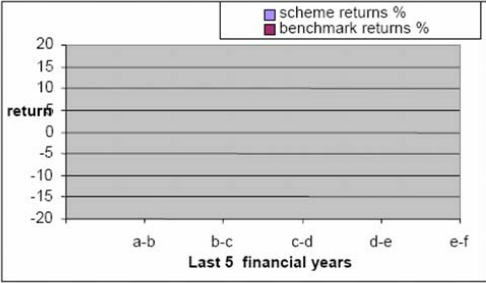
Scheme Re-opens for continuous sale and repurchase on:

This Key Information Memorandum (KIM) sets forth the information, which a prospective investor ought to know before investing. For further details of the scheme/Mutual Fund, due diligence certificate by the AMC, Key Personnel, investors' rights & services, risk factors, penalties & pending litigations etc. investors should, before investment, refer to the Scheme Information Document and Statement of Additional Information available free of cost at any of the Investor Service Centres or distributors or from the website www. -----.

The Scheme particulars have been prepared in accordance with Securities and Exchange Board of India (Mutual Funds) Regulations 1996, as amended till date, and filed with

Securities and Exchange Board of India (SEBI). The units being offered for public subscription have not been approved or disapproved by SEBI, nor has SEBI certified the accuracy or adequacy of this KIM.

| | | | |
|--|--|--|------------|
| Investment Objective | | | |
| Asset Allocation Pattern of the scheme | Types of Instruments | Normal Allocation (% of Net Assets) | |
| | | | |
| | | | |
| Risk Profile of the Scheme | Mutual Fund Units involve investment risks including the possible loss of principal. Please read the SID carefully for details on risk factors before investment. Scheme specific Risk Factors are summarized below: | | |
| Plans and Options | | | |
| Applicable NAV (after the scheme opens for repurchase and sale) | | | |
| Minimum Application Amount/ Number of Units | Purchase | Additional Purchase | Repurchase |
| Despatch of Repurchase (Redemption) Request | Within 10 working days of the receipt of the redemption request at the authorised centre of the -- ---- Fund. | | |
| Benchmark Index | | | |
| Dividend Policy | | | |
| Name of the Fund Manager | | | |
| Name of the Trustee | | | |

| | | | |
|--|---|-------------------------|----------------------------|
| Company | | | |
| <p>Performance of the scheme :</p> <p>[In case of a new scheme, the statement should be given “This scheme does not have any performance track record”] Or [In case of a scheme in existence, the return figures shall be given for that scheme only, as per the For a scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised Returns and for scheme which is in existence for less than 1 year, the returns would be absolute returns since inception. Absolute returns for each financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.]</p> | Compounded Annualised Returns | Scheme Returns % | Benchmark Returns % |
| | Returns for the last 1 year | | |
| | Returns for the last 3 years | | |
| | Returns for the last 5 years | | |
| | Returns since inception | | |
| | <p>Absolute Returns for each financial year for the last 5 years</p>  | | |
| Expenses of the | New Fund Offer | Continuous Offer | |

| Scheme | Period | |
|---|---|---|
| <p>(i) Load Structure (ii) Recurring expenses</p> | <p>Entry load : Exit load : CDSC (if any):</p> | <p>Entry load : Exit load : CDSC (if any):</p> |
| | <p>First Rs. 100 crores of the average weekly net assets : Next Rs. 300 crores of the average weekly net assets : Next Rs. 300 crores of the average weekly net assets : Balance :</p> | <p>Actual expenses for the previous financial year: ---- (Not Applicable in case of a new scheme)</p> |
| | <p>Waiver of Load for Direct Applications</p> <p>The applicable procedure should be given in brief.</p> | |
| <p>Tax treatment for the Investors (Unitholders)</p> | <p>Investor will be advised to refer to the details in the Statement of Additional Information and also independently refer to his tax advisor.</p> | |
| <p>Daily Net Asset Value (NAV) Publication</p> | <p>The NAV will be declared on all ----- days and will be published in 2 newspapers. NAV can also be viewed on www.____ and www.amfiindia.com [You can also telephone us at ----- (optional)].</p> | |
| | | |

| | | |
|---|--|--|
| For Investor Grievances please contact | Name and Address of Registrar | Name, address, telephone number, fax number, e-mail i.d. ----- |
| Unitholders' Information | Give the frequency and the policy of the fund house for the providing the Accounts Statement, Annual Financial results and Half yearly portfolio to the investors. | |

Date:

N.B. Data and information shall be up-to-date but in no case older than 30 days from the date of KIM

Multiple Choice Questions

1. NFOs other than ELSS can be open for a maximum of:
 - a. 7 days
 - b. 10 days
 - c. 15 days
 - d. 30 days

2. Legally, SAI is part of the SID
 - a. True
 - b. False

3. Offer documents of mutual fund schemes are approved by SEBI
 - a. True
 - b. False

4. Application form is attached to
 - a. SID
 - b. SAI
 - c. KIM

- d. None of the above
5. KIM has to be updated every 6 months
- a. True
 - b. False

Answers

1 - c, 2 - a, 3 - b, 4 - c, 5 - b

Checklist of Learning Points

- ☑ Under the SEBI guidelines, NFOs other than ELSS can remain open for a maximum of 15 days. Allotment of units or refund of moneys, as the case may be, should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale / re-purchase within 5 business days of the allotment.
- ☑ Investors get to know the details of any NFO through the Offer Document, which is one of the most important sources of information about the scheme for investors. Investments by the investor are governed by the principle of *caveat emptor* i.e. let the buyer beware.
- ☑ Mutual Fund Offer Documents have two parts: (a) Scheme Information Document (SID), which has details of the scheme (b) Statement of Additional Information (SAI), which has statutory information about the mutual fund that is offering the scheme.
- ☑ In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID. Both documents need to be updated regularly.
- ☑ Offer Documents in the market are “vetted” by SEBI, though SEBI does not formally “approve” them.
- ☑ KIM is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

5. Fund Distribution and Channel Management Practices

Learning Objective

This unit seeks to give you an understanding of the distribution channels through which mutual fund schemes reach the investors, and how these channels are managed.

Transactional aspects of selling and buying units are detailed in Unit 7.

5.1 Distribution Channels

5.1.1 Traditional Distribution Channels

Individual

Historically, individual agents would distribute units of Unit Trust of India and insurance policies of Life Insurance Corporation. They would also facilitate investments in Government's Small Savings Schemes. Further, they would sell Fixed Deposits and Public Issues of shares of companies, either directly, or as a sub-broker of some large broker.

UTI, LIC or other issuer of the investment product (often referred to in the market as "product manufacturers") would advertise through the mass media, while an all-India field force of agents would approach investors to get application forms signed and collect their

cheques. The agents knew the investors' families personally – the agent would often be viewed as an extension of the family.

Over the last two decades or so, a number of changes happened:

- Several new insurance and mutual fund companies commenced operations.
- The universe of investment products available for investors multiplied.
- Investors are better informed about many products and their features.
- Technologies like the internet and data mining software opened the doors to newer ways of targeting investors, sharing information with them, and putting through their transactions.
- Companies started offering products in more and more locations, thus increasing the pressure on the product manufacture-to-agent, single level distribution architecture.
- A need was felt for newer formats of distribution that would leverage on the above to generate much higher volumes in the market.

Institutional Channels

The changing competitive context led to the emergence of institutional channels of distribution for a wide spectrum of financial products. This comprised:

- Brokerage firms and other securities distribution companies, who widened their offering beyond company Fixed Deposits and public issue of shares.
- Banks, who started viewing distribution of financial products as a key avenue to earn fee-based income, while addressing the investment needs of their customers.

Some operated within states; many went national. A chain of offices manned by professional employees or affiliated sub-brokers became the face of mutual fund distribution. Brand building, standardized processes and technology sharing became drivers of business for these institutions – unlike the personal network which generated volumes for the individual agents.

Limitations of employee bandwidth and staff strength meant that product manufacturers preferred to deal with a few institutions. The benefit was that they could reach out to hundreds of locations, while having to negotiate deals with only a select few in the head office of the distributing institution. AMCs appointed Channel Managers on their rolls, whose job it was, to get the best out of these institutional distribution channels.

The institutional channels started attracting agents as sub-brokers. Many individual agents opted to associate with the institutional channels, so that they could give their customers the benefit of newer technologies and services (which the agents found too costly to offer on their own).

Thus, the distribution setup has got re-aligned towards a mix of:

- Independent Financial Advisors (IFAs), who are individuals. The bigger IFAs operate with support staff who handle back-office work, while they themselves focus on sales and client relationships.
- Non-bank distributors, such as brokerages, securities distribution companies and non-banking finance companies
- Bank distributors

Ownership of all-India or regional network of locations meant that the institutional channels could deal with product manufacturers as equals, and negotiate better terms than what the agents could manage.

Down the line, the AMCs also started exploring other channels of distribution. Post offices and self-help groups are examples of such alternate channels. Alternate Channel Managers on the rolls of the company are responsible for such exploratory thrusts.

5.1.2 Newer Distribution Channels

Internet

The internet gave an opportunity to mutual funds to establish direct contact with investors. Direct transactions afforded scope to optimize on the commission costs involved in distribution.

Investors, on their part, have found a lot of convenience in doing transactions instantaneously through the internet, rather than get

bogged down with paper work and having to depend on a distributor to do transactions. This has put a question mark on the existence of intermediaries who focus on pushing paper, but add no other value to investors.

A few professional distributors have rightly taken the path of value added advice and excellent service level to hold on to their customers and develop new customer relationships. Many of them offer transaction support through their own websites.

A large mass of investors in the market need advice. The future of intermediaries lies in catering to their needs, personally and / or through a team and / or with support of technology.

Stock Exchanges

The institutional channels have had their limitations in reaching out deep into the hinterland of the country. A disproportionate share of mutual fund collections has tended to come from corporate and institutional investors, rather than retail individuals for whose benefit the mutual fund industry exists.

Stock exchanges, on the other hand, have managed to ride on the equity cult in the country and the power of communication networks to establish a cost-effective all-India network of brokers and trading terminals. This has been a successful initiative in the high-volume low-margin model of doing business, which is more appropriate and beneficial for the country.

Over the last few months, SEBI has facilitated buying and selling of mutual fund units through the stock exchanges. Both NSE and

BSE have developed mutual fund transaction engines for the purpose. These are discussed in Unit 7. The underlying premise is that the low cost and deeper reach of the stock exchange network can increase the role of retail investors in mutual funds, and take the mutual fund industry into its next wave of growth.

While the transaction engines are a new phenomenon, stock exchanges always had a role in the following aspects of mutual funds, which were discussed in Unit 1:

- Close-ended schemes are required to be listed in a stock exchange
- ETFs are bought and sold in the stock exchange.

5.1.3 Pre-requisites to become Distributor of a Mutual Fund

A fund may appoint an individual, bank, non-banking finance company or distribution company as a distributor. No SEBI permission is required before such appointment.

SEBI has prescribed a Certifying Examination, passing in which is compulsory for anyone who is into selling of mutual funds, whether as IFA, or as employee of a distributor or AMC. Qualifying in the examination is also compulsory for anyone who interacts with mutual fund investors, including investor relations teams and employees of call centres.

In order to be eligible to sell or market mutual funds, the following are compulsory:

- The individual needs to pass the Certifying Examination prescribed by SEBI. Distributors / employees who were above the age of 50 years, and had at least 5 years of experience as on September 30, 2003 were exempted. But they need to attend a prescribed refresher course.
- KYD Requirements

As part of Sebi's drive to streamline the distribution process of mutual fund products, AMFI has introduced the KYD process to verify the correctness of the information provided in the registration documents and to have verification of the ARN holders.

The process consists of document verification and bio-metric process

- Self-attested copy of the PAN card and specific documents as proof of address to be submitted along with application form at the CAMS- PoS
- Bio-metric process consists of taking the impression of the index finger of the right hand of the ARN holder. This will be done at the PoS at the time submission of documents
- In case of non-individual distributors, bio-metric process will be conducted on specified authorized persons

- An acknowledgement confirming the completion of KYD process is received from the CAMS-PoS
- A photocopy of the acknowledgement has to be sent to all the AMCs with whom the distributor is empanelled

The new rules is applicable to new registrations and renewals have come to effect from September 1, 2010,

- After passing the examination and completing KYD requirements, the next stage is to register with AMFI. On registration, AMFI allots an AMFI Registration Number (ARN). Individuals from the exempted category described above can obtain the ARN without passing the Certifying Examination, provided they have attended the prescribed refresher course.
- Armed with the ARN No., the IFA / distributor / stock exchange broker can get empanelled with any number of AMCs. Alternatively, they can become agents of a distributor who is already empanelled with AMCs. Empanelment with the AMC, or enrolment as an agent of an empanelled distributor is compulsory to be able to sell mutual fund schemes and earn the commissions.

Institutions that are into distribution of mutual funds need to register with AMFI. Besides, all their employees who are into selling mutual funds need to have an ARN.

5.1.4 Conditions for Empanelment

Empanelment with an AMC is a simple process. There is a standard Request for Empanelment Form to be filled. This provides for basic details, such as

- Personal Information of applicant – Name of person, age, Trade Name, Contact Information, ARN, PAN, Income tax category (such as Resident Individual, Company, Non-Resident Indian, Foreign Company)
- Names and contact information of key people handling sales and operations
- Business details, such as office area, number of branches, number of employees, geographical area covered, years of experience, number of investors, number of agents / sub-brokers, fund houses already empanelled in, size of AUM etc.
- Bank details and preferences regarding Direct Credit of brokerage in the bank account
- Preferences regarding receiving information from the AMC
- Nominee
- The applicant also needs to sign a declaration, which provides for the following:
 - Correctness and completeness of information provided

- Commitment to keep all the transactional information confidential
- Commitment to abide by instructions given, as also statutory codes, guidelines and circulars
- Not to issue advertisement or publicity material other than that provided by the AMC or pre-approved by the AMC
- Ensure that the risk factors are mentioned along with performance and other related information
- Provide all the information and documents that the AMC may ask for from time to time
- Ensure that all employees who are engaged in selling or marketing of mutual funds have an ARN.
- Undertake not to rebate commission back to investors, or attract investors through temptation of rebate / gifts, passback of commission etc.
- Power to the AMC to terminate the empanelment at any time
- Some AMCs directly empanel only distributors who are likely to generate adequate business – and request others to work under one or the other empanelled distributors.
- At times, AMCs link the levels of commission to the volumes generated. In such cases, an agent might find it beneficial to work under an established distributor.

5.2 Channel Management Practices

5.2.1 Commission Structures

There are no SEBI regulations regarding the minimum or maximum commission that distributors can earn. However, SEBI has laid down limits on what the total expense (including commission) in a scheme can be. This is discussed in Unit 6. Any excess will need to be borne by the AMC i.e. it cannot be charged to the scheme.

The commission structures vary between AMCs. Even for the same AMC, different commissions are applicable for different kinds of schemes. Two kinds of commission are earned by distributors on their mobilization:

Initial or Upfront Commission, on the amount mobilized by the distributor.

The scheme application forms carry a suitable disclosure to the effect that the upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor. Some distributors have worked out standardized contracts with their clients, where either a fixed amount per period, or a percentage of the transaction value is recovered as fees. As part of the contract, some banks debit the commission to the investor's savings bank account held with the bank.

Investors should make sure that the commission costs they incur are in line with the value they get.

Trail commission, calculated as a percentage of the net assets attributable to the Units sold by the distributor.

The trail commission is normally paid by the AMC on a quarterly basis. Since it is calculated on net assets, distributors benefit from increase in net assets arising out of valuation gains in the market.

For example, suppose an investor has bought 1000 units at Rs 10 each. The distributor who procured the investment may have been paid an initial commission calculated as a percentage on 1000 units X Rs 10 i.e. Rs 10,000.

Later, suppose the NAV of the scheme goes up to Rs 15. Trail commission is payable on 1000 units X Rs 15 i.e. Rs 15,000 – not the Rs 10,000 mobilised.

Further, unlike products like insurance, where agent commission is paid for a limited number of years, a mutual fund distributor is paid a commission for as long as the investor's money is held in the fund.

Such indexing of agent commissions to the share market, and the absence of a time limitation to earning it, are unique benefits that make it attractive for distributors to sell mutual funds.

Smart distributors have accumulated a portfolio of loyal investors to whom they offer superior service. The trail commission on these investments ensures a steadily rising income for the distributor. Additional investments from the same investors, and other investors referred by the current investors, help them grow the portfolio.

5.2.2 Multi-level Distribution Channel

As seen earlier, large distributors have agents / sub-brokers working under them. Being the principal, the distributor is bound by the acts of agents / sub-brokers. The distributor therefore needs to ensure that the agents comply with all the regulations.

Typically, AMCs structure their relationship with distributors as Principal to Principal. Therefore, the AMC is not bound by the acts of the distributor, or the distributor's agents or sub-brokers.

5.2.3 ACE and AGNI

Every person who is into selling of mutual funds should be familiar with the AMFI Code of Ethics (ACE) and AMFI's Guidelines & Norms for Intermediaries (AGNI). These were discussed in Unit 3.

5.2.4 SEBI Regulations related to Sales Practices

Distributors can claim commission on investments made through them by their clients. However, no commission is payable on their own investments.

The distributors have to disclose all the commissions (in the form of trail commission or any other mode) payable to them for the different competing schemes of various mutual funds from amongst which the scheme is being recommended to the investor.

The practice of rebating i.e., sharing part of the commission earned with the investors, is banned. This was discussed in the section on AGNI in Unit 3.

5.2.5 SEBI Advertising Code

The important provisions are listed below. The requirements regarding returns will be better appreciated, after reading Unit 8.

- Advertisements shall be truthful, fair and clear and shall not contain a statement, promise or forecast which is untrue or misleading.
- All statements made and facts reported in sales literature of a scheme should be substantiated with the disclosures made in the SID & SAI.
- The advertisement shall not contain information, the accuracy of which is to any extent dependent on assumptions.
- The fact that Mutual Fund investments are prone to risks of fluctuation in NAV, uncertainty of dividend distributions, etc. needs to be adequately brought to the notice of unit holders or public in all communications.
- Use of exaggerated or unwarranted claims, superlatives and opinions, not substantiated by available public data shall be refrained from and future forecasts and estimates of growth shall be avoided.
- In hoardings / posters, the statement, "Mutual Fund investments are subject to market risks, read the offer document carefully before investing", is to be displayed in black letters of at least 8 inches height or covering 10% of the display area, on white background.

- In audio-visual media, the statement “Mutual Fund investments are subject to market risks, read the offer document carefully before investing” (without any addition or deletion of words) has to be displayed on the screen for at least 5 seconds, in a clearly legible font-size covering at least 80% of the total screen space and accompanied by a voice-over reiteration. The remaining 20% space can be used for the name of the mutual fund or logo or name of scheme, etc.
- Advertisements through audio media like radio, cassettes, CDs etc. shall also read the above statement in a way that is easily understandable to the listeners over a period of 5 seconds.
- Tombstone advertisements can only give basic information about a
 - Mutual fund registered with SEBI whose Statement of Additional Information is filed with SEBI or
 - Scheme which is already launched and is in existence and whose Scheme information document is available.
 - They must contain the following minimum information:
 - Name of the Mutual Fund and the Asset Management Company (AMC).
 - Scheme name and classification (i.e. income/growth etc.) indicating investment objectives of the scheme.
 - Logo or trademark or corporate symbol, if any.

- General services offered i.e. frequency of Net Asset Value (NAV) disclosure, liquidity etc.
- Contact details for further information and scheme literature, etc.
- Entry and/or exit loads, if applicable if the advertisement is for a scheme.

The following information is *prohibited* from tombstone advertisements:

- Declaration of NAV and performance of the scheme.
- Promise of any returns except in case of assured returns schemes.
- Comparisons and usage of ranking given by a third party.
- Product Launches - mean and include all advertisements issued during the period in which the NFO is open.

In such advertisements, risk factors may not be mentioned. However, a general statement to refer to the SID for details is necessary.

- Product launch advertisements shall be used only for launch and/ or re-launch of schemes. These advertisements must contain the following minimum information:
 - Name of the Mutual Fund and the AMC.

- Scheme name and classification (i.e. income/growth etc.)
- Investment objective, asset allocation or highlights thereof.
- Terms of issue and mode of sale and redemption of units.
- Investor benefits and general services offered i.e. frequency of NAV disclosure etc.
- In case of assured return schemes, the resources that back such assurances.
- Logo or trademark or corporate symbol, if any.
- Risk factors as stated in the SID with a font equal to that of the text of the highlights.
- Applicable load structure
- Contact information of person from whom a copy of SID and SAI and Key Information Memorandum along with an application form may be obtained.
- The statement that an investor should read the SID and SAI before investing in the scheme.
- In addition, any other information as may be required by the Advertisement Code or voluntarily disclosed by the Mutual Fund as long as such information is not specifically prohibited by these Guidelines.

The following information is prohibited in product launch advertisements

- Declaration of NAV and performance figures of any of the previous schemes unless such performance statements conform to these Guidelines.
- Comparisons with other Mutual Funds or schemes.
- Ranking by any ranking entity

All that is stated in the Product Launch advertisement should be substantiated with the SID & SAI

- Performance advertisements shall adhere to the following guidelines:
 - Such advertisements shall identify the nature of the scheme and its basic investment objective.
 - The dividends declared or paid shall also be mentioned in Rupees per unit along with the face value of each unit of that scheme and the prevailing NAV at the time of declaration of the dividend.
 - Only compounded annualized yield shall be advertised, calculated using the prescribed procedure, if the scheme has been in existence for more than 1 year. All performance calculations shall be based only on NAV and payouts to the unit holders. The calculation of returns shall assume that all payouts during the period have been reinvested in the

scheme at the then prevailing NAV and this shall be clarified in the advertisements. The type of plan or option of the scheme for which yield is advertised shall also be mentioned.

- The aforesaid annualized yields when used shall be shown for the, last 1 year, 3 years, 5 years and since the launch of the scheme. For Funds in existence for less than one year, performance may be advertised in terms of total returns and such return shall not be annualized.
- In case of Money Market schemes or cash and liquid plans, wherein investors have very short investment horizon, the performance can be advertised by simple annualisation of yields if a performance figure is available for at least 7 days, 15 days and 30 days provided it does not reflect an unrealistic or misleading picture of the performance or future performance of the scheme.
- All advertisements displaying returns or yields must disclose in the main body of the advertisement, immediately after the returns or yields and in the same font that past performance may or may not be sustained in future. If the returns or yield are unrealistically higher due to extraordinary circumstances (e.g. rise or fall in interest rates etc.), the same shall be clarified in the advertisement.
- All performance data contained in the advertisement must be of most recent practicable date depending upon the type of communication. In any case, the data used must not be

older than the most recent calendar quarter ended prior to the release of the advertisement.

- Appropriate benchmark(s) and identical time periods shall be used for comparisons.
- While advertising returns by assuming reinvestment of dividends, if distribution taxes are excluded while calculating the returns, this fact shall also be disclosed
- While advertising pay out of dividends, all advertisements shall disclose, immediately below the dividend figure (in percentage or in absolute terms) and in the same font size that the NAV of the scheme, pursuant to payment of dividend would fall to the extent of payout and statutory levy (if applicable)
- No AMC(s) or Mutual Fund shall use rankings except those developed and produced by a "Ranking Entity" that:
 - Provides general information about AMC(s) or Mutual Funds to the public; and
 - Is independent of the AMC(s) or Mutual Fund and its affiliates; and
 - Whose services have not been procured by the AMC(s) or Mutual Fund or any of its affiliates to assign a ranking to the AMC(s) or Mutual Fund.

- Headline or Prominent Statements
 - A headline or other prominent statement must not state or imply that an AMC(s) and/or Mutual Fund is the best performer in a category unless it is actually ranked first in the category.
- All advertisements and Sales Literature containing an AMC(s)/Mutual Fund ranking must prominently disclose, with respect to the ranking:
 - The name of the category (e.g. income/growth).
 - The number of AMC(s)/Mutual Funds in the category.
 - The name of the Ranking Entity.
 - The length of the period and the ending date, or the first day of the period and the ending date.
 - Criteria on which the ranking is based.
 - For schemes assessing front-end sales loads, whether the ranking takes into account sales charge.
 - In case the ranking is for a period where fees/expenses have been waived and the waiver or advancement had a material effect on the yield for that period, the same should be disclosed in the advertisement.
 - The publisher of the ranking data.

- If the ranking consists of a symbol (for e.g., a star system) rather than a number, the advertisement or Sales Literature must disclose the meaning of the symbol (for e.g., a four-star ranking indicates that the fund is in the top 30% of all Mutual Fund schemes).
- All advertisements and/ or Sales Literature containing rankings must disclose prominently in the main body of such communication that past performance is not a guarantee of future results.
- All ranking set forth in an advertisement and/ or Sales Literature must be current to the most recent calendar quarter ended, in case of advertising prior to the submission for publication or in case of Sales Literature prior to use.
- For schemes other than money market mutual funds
 - Advertisements and/ or Sales Literature must not use rankings based on yield for a period of less than one year.
 - A ranking based on compounded annualized yield must be based on rankings supplied by the same Ranking Entity, relating to the same category and the same time period and based on returns for
- One year period for scheme in existence for at least one year;
- One and five year periods for schemes in existence for at least five years, and

- One, five and ten year periods for scheme in existence for at least ten years.
- However, if rankings for such one, five and ten year time periods are not published by the Ranking Entity, then rankings representing short, medium and long term performance must be provided in place of rankings for the required time periods.
- Mutual Funds shall not offer any indicative portfolio and indicative yield. No communication regarding the same in any manner whatsoever, shall be issued by any Mutual Fund or distributors of its products.
- Disclosure of risk factors in advertisements
 - All advertisements announcing the launch of a scheme and those which solicit subscription to the scheme shall disclose all the risk factors.
 - All advertisements containing performance information, advertising yield/return etc. shall also disclose all the risk factors.
 - Any advertisement which discloses only the latest NAV, sale and/or repurchase price without any reference to the corresponding past figures may not disclose all the risk factors. However, it shall include a statement that 'investors are advised to read the offer document before investing in the scheme'.

Multiple Choice Questions

1. Institutional distributors build reach through
 - a. Employees
 - b. Agents
 - c. Sub-brokers
 - d. Any of the above

2. The maximum initial commission that an AMC can pay to distributors is:
 - a. Nil
 - b. 0.05%
 - c. 1%
 - d. 2%

3. The distributor can charge a fee from the investor.
 - a. True
 - b. False

4. Stock exchange brokers are permitted to distribute mutual funds without the requirement of passing the certifying test
 - a. True
 - b. False
5. Trail commissions are linked to valuation of portfolio in the market
 - a. True
 - b. False

Answers

1 - d, 2 - a, 3 - a, 4 - b, 5 - a

Checklist of Learning Points

- ☑ The changing competitive context has led to the emergence of institutional channels of distribution, to supplement the individuals who distribute mutual funds. Institutional channels build their reach through employees, agents and sub-brokers.
- ☑ AMCs keep exploring newer channels of distribution to increase the size of assets managed.
- ☑ The internet has increased the expectations of advice that investors have from their distributors.
- ☑ The stock exchange brokers have become a new channel for distribution of mutual funds. These brokers too need to pass the prescribed test, get the AMFI Registration No. and get themselves empanelled with AMCs whose schemes they want to distribute.
- ☑ The scheme application forms carry a suitable disclosure to the effect that the upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor.
- ☑ AMCs pay a trail commission for the period the investment is held in the scheme.
- ☑ Since trail commission is calculated as a percentage on AUM, distributors get the benefit of valuation gains in the market.

6. Accounting, Valuation and Taxation

Learning Objectives

Your learning of mutual funds is incomplete, if you do not know a few aspects of accounting of mutual fund schemes, valuation of securities in the scheme's portfolio, calculation of net asset value, and the impact of taxation on various types of mutual fund schemes and investors in these schemes.

The role of taxation in recommending mutual fund schemes to investors is covered in Unit 10.

6.1 Accounting and Expenses

6.1.1 Net Assets of Scheme

Let us understand the concept with a simple example.

Investors have bought 20crore units of a mutual fund scheme at Rs 10 each. The scheme has thus mobilized 20 crore units X Rs 10 per unit i.e. Rs 200 crore.

An amount of Rs 140 crore, invested in equities, has appreciated by 10%.

The balance amount of Rs 60 crore, mobilized from investors, was placed in bank deposits.

Interest and dividend received by the scheme is Rs 8 crore, scheme expenses paid is Rs 4 crore, while a further expense of Rs 1 crore is payable.

If the above details are to be captured in a listing of assets and liabilities of the scheme, it would read as follows:

| | Amount (Rs cr.) |
|--|-----------------|
| <u>Liabilities</u> | |
| Unit Capital (20crore units of Rs10 each) | 200 |
| Profits {Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid) minus Rs 1 crore (expenses payable)} | 3 |
| Capital Appreciation on Investments held {10% of Rs 140 crore} | 14 |
| Unit-holders' Funds in the Scheme | 217 |
| Expenses payable | 1 |
| Scheme Liabilities | 218 |
| | |
| <u>Assets</u> | |
| Market value of Investments (Rs 140 crore + 10%) | 154 |
| Bank Deposits {Rs60crore (original) plus Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid)} | 64 |
| Scheme Assets | 218 |

The unit-holders' funds in the scheme is commonly referred to as "net assets".

As is evident from the table:

- Net assets includes the amounts originally invested, the profits booked in the scheme, as well as appreciation in the investment portfolio.
- Net assets go up when the market prices of securities held in the portfolio go up, even if the investments have not been sold.
- A scheme cannot show better profits by delaying payments. While calculating profits, all the expenses that relate to a period need to be considered, irrespective of whether or not the expense has been paid. In accounting jargon, this is called accrual principle.
- Similarly, any income that relates to the period will boost profits, irrespective of whether or not it has been actually received in the bank account. This again is in line with the accrual principle.

6.1.2 Net Asset Value (NAV)

In the market, when people talk of NAV, they refer to the value of each unit of the scheme. This is equivalent to:

Unit-holders' Funds in the Scheme ÷ No. of Units

In the above example, it can be calculated as:

Rs 217 crore ÷ 20 crore

i.e. Rs 10.85 per unit.

An alternate formula for calculating NAV is:

$(\text{Total Assets minus Liabilities other than to Unit holders}) \div \text{No. of Units}$

i.e. $(\text{Rs } 218 \text{ crore} - \text{Rs } 1 \text{ crore}) \div 20 \text{ crore}$

i.e. Rs 10.85 per unit.

From the above, it follows that:

- Higher the interest, dividend and capital gains earned by the scheme, higher would be the NAV.
- Higher the appreciation in the investment portfolio, higher would be the NAV.
- Lower the expenses, higher would be the NAV.

The summation of these three parameters gave us the *profitability metric*, which was introduced in Unit 1 as being equal to:

- (A) Interest income
- (B) + Dividend income
- (C) + Realized capital gains
- (D) + Valuation gains
- (E) – Realized capital losses
- (F) – Valuation losses
- (G) – Scheme expenses

6.1.3 Mark to Market

The process of valuing each security in the investment portfolio of the scheme at its market value is called '*mark to market*' i.e. marking the securities to their market value. Why is this done?

The NAV is meant to reflect to true worth of each unit of the scheme, because investors buy or sell units on the basis of the information contained in the NAV. If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought. Valuing shares of a company at their acquisition cost, say Rs 15, is meaningless, if those shares have appreciated to, say Rs 50. If the scheme were to sell the shares at the time, it would recover Rs 50 – not Rs 15. When the NAV captures the movement of the share from Rs 15 to Rs 50, then it is meaningful for the investors.

Thus, marking to market helps investors buy and sell units of a scheme at fair prices, which are determined based on transparently calculated and freely shared information on NAV. As will be seen in Unit 8, such mark-to-market based NAV also helps in assessing the performance of the scheme / fund manager.

6.1.4 Sale Price, Re-purchase Price and Loads

A distinctive feature of open-ended schemes is the ongoing facility to acquire new units from the scheme ("sale" transaction) or sell units back to the scheme ("re-purchase transaction").

In the past, schemes were permitted to keep the Sale Price higher than the NAV. The difference between the Sale Price and NAV

was called the "entry load". If the NAV of a scheme was Rs 11.00 per unit, and it were to charge entry load of 1%, the Sale Price would be Rs 11 + 1% on Rs 11 i.e. Rs 11.11.

Schemes are permitted to keep the Re-purchase Price lower than the NAV. The difference between the NAV and Re-purchase Price is called the "exit load". If the NAV of a scheme is Rs 11.00 per unit, and it were to charge exit load of 1%, the Re-purchase Price would be Rs 11 – 1% on Rs 11 i.e. Rs 10.89.

Schemes can also calibrate the load when investors offer their units for re-purchase. Investors would be incentivized to hold their units longer, by reducing the load as the unit holding period increased. For instance, load would be 4% if the investor were to exit in year 1, 3% if the investor were to exit in year 2, and so on. Such structures of load are called "Contingent Deferred Sales Charge (CDSC)".

Earlier, schemes had the flexibility to differentiate between different classes of investors within the same scheme, by charging them different levels of load. Further, all the moneys collected as loads were available for the AMC to bear various selling expenses. There were liberal limits on how much could be charged as loads.

The position since August 1, 2009 is that:

- SEBI has banned entry loads. So, the Sale Price needs to be the same as NAV.

- Exit loads / CDSC in excess of 1% of the redemption proceeds have to be credited back to the scheme immediately i.e. they are not available for the AMC to bear selling expenses.
- Exit load structure needs to be the same for all unit-holders representing a portfolio.

6.1.5 Expenses

Two kinds of expenses come up:

Initial Issue Expenses – These are one-time expenses that come up when the scheme is offered for the first time (NFO). These need to be borne by the AMC.

Investors who review the financial statements of old schemes may find an item called “Issue expenses not written off”. The background to this is that earlier, schemes could charge initial issue expenses to the scheme, upto 6% of the amount mobilized in the NFO. Thus, if an NFO mobilized Rs 500 crore, Rs 30 crore could be charged to the scheme as initial issue expenses, provided such expenditure was actually incurred.

If the entire amount were treated as an expense, then, the NAV would go down to that extent [follows from the *profitability metric* discussed earlier]. Thus, a scheme whose units have a face value of Rs 10 would need to start with an NAV of Rs 10 less 6% i.e. Rs 9.40, if the entire issue expenses were treated as an immediate expense (in accounting terminology, such expensing is called “*written off*”). In order to prevent initial issue expenses from

causing a drastic fall in NAV, the guidelines permitted an accounting treatment called “deferred load”.

Deferred load operated on the principle that if the scheme were to last for 4 years, then the initial issue expenses relate to money that will be in the scheme for 4 years. So the initial issue expenses could be written off over 4 years. That part of the initial issue expense that related to periods that have passed would be written off (which will reduce the NAV); the part that related to a future time period, was treated as an asset of the scheme, called “Issue expenses not written off”. The following table illustrates the point, assuming a 4 year scheme incurred initial issue expenses of Rs 8 crore.

| End of Year | Issue Expenses Written Off (which reduces the NAV) | Issue Expenses not Written Off |
|-------------|---|-----------------------------------|
| 1 | Rs 2 cr | Rs 8 cr less Rs 2 cr i.e. Rs 6 cr |
| 2 | Rs 2 cr | Rs 6 cr less Rs 2 cr i.e. Rs 4 cr |
| 3 | Rs 2 cr | Rs 4 cr less Rs 2 cr i.e. Rs 2 cr |
| 4 | Rs 2 cr | Rs 2 cr less Rs 2 cr i.e. Rs 0 cr |

As mentioned earlier, AMC's need to bear the initial issue expenses now. So, deferred load is not applicable for newer schemes.

Recurring Expenses – These can be charged to the scheme. Since the recurring expenses drag down the NAV, SEBI has laid down the expenses, which can be charged to the scheme. An indicative list is as follows:

- Fees of various service providers, such as Trustees, AMC, Registrar & Transfer Agents, Custodian, & Auditor
- Selling expenses including scheme advertising and commission to the distributors
- Expenses on investor communication, account statements, dividend / redemption cheques / warrants
- Listing fees and Depository fees
- Service tax

The following expenses *cannot* be charged to the scheme:

- Penalties and fines for infraction of laws.
- Interest on delayed payment to the unit holders.
- Legal, marketing, publication and other general expenses not attributable to any scheme(s).
- Fund Accounting Fees.
- Expenses on investment management/general management.

- Expenses on general administration, corporate advertising and infrastructure costs.
- Depreciation on fixed assets and software development expenses.

6.1.6 Recurring Expense Limits

SEBI has stipulated the following annual limits on recurring expenses (including management fees) for schemes other than index schemes:

| Net Assets (Rs crore) | Equity Schemes | Debt Schemes |
|--------------------------|----------------|--------------|
| Upto Rs 100 crore | 2.50% | 2.25% |
| Next Rs 300 crore | 2.25% | 2.00% |
| Next Rs 300 crore | 2.00% | 1.75% |
| Excess over Rs 700 crore | 1.75% | 1.50% |

The above percentages are to be calculated on the average net assets of the scheme.

Within the above limits, the management fees cannot exceed:

- 1.25% on the first Rs 100 crore of net assets of a scheme
- 1.00% on the balance net assets.

Management fees cannot be charged by liquid schemes and other debt schemes on funds parked in short term deposits of commercial banks.

The expense limits for index schemes (including Exchange Traded Funds) is as follows:

- Recurring expense limit (including management fees) 1.50%
- Management fees 0.75%

As regards Fund of Funds, the recurring expense limit (including management fees) was previously 0.75%.

The limits for Fund of Funds have been revised. The scheme can choose between the following:

- a) Management Fee limit of 0.75% of net assets; or
- b) Management Fees plus Scheme Running Expenses plus Charges levied by underlying schemes (weighted average of total expense ratio of underlying schemes) – limit of 2.50% of net assets.

The Scheme Information Document is to mention which of these limits is being adopted for the scheme.

Schemes existing as on July 29, 2010 can adopt either of the above limits with the permission of trustees, and after giving existing unit-holders the option of exiting from the scheme at the full NAV.

6.1.7 Dividends & Distributable Reserves

As seen earlier, in the calculation of net assets, investments are taken at their market value. This is done, to ensure that sale and re-purchase transactions are effected at the true worth of the unit, including the gains on the investment portfolio.

Similarly, it was seen that income and expense are accounted on the basis of accrual principle. Therefore, even though they may not have been received or paid, they are accrued as income or expense, if they relate to a period until the accounting date.

Unlike accrued income (which is receivable - it is only a question of time) and accrued expense (which is payable - it is only a question of time), valuation gains in the scheme's portfolio may never get translated into real gains - it is NOT just a question of time. The securities need to be sold, for the scheme to be sure about the capital gains i.e. the capital gains need to be *realized*.

Since the investments in the portfolio are not yet sold, the gains in them are on paper - they are not *realised*. They will be realized, when those investments are sold.

SEBI guidelines stipulate that dividends can be paid out of *distributable reserves*. In the calculation of distributable reserves:

- All the profits earned (based on accrual of income and expenses as detailed above) are treated as available for distribution.
- Valuation gains are ignored. But valuation losses need to be adjusted against the profits.
- That portion of sale price on new units, which is attributable to valuation gains, is not available as a distributable reserve.

This conservative approach to calculating distributable reserves ensures that dividend is paid out of real profits, after providing for all possible losses.

6.1.8 Key Accounting and Reporting Requirements

- The accounts of the schemes need to be maintained distinct from the accounts of the AMC. The auditor for the AMC has to be different from that of the schemes.
- Norms are prescribed on when interest, dividend, bonus issues, rights issues etc. should be reflected for in the accounts.
- NAV is to be calculated upto 4 decimal places in the case of index funds, liquid funds and other debt funds.
- NAV for equity and balanced funds is to be calculated upto at least 2 decimal places.

- Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.
- The frequency of disclosures of NAV, Portfolio and Scheme accounts was discussed in Unit 3.

6.2 Valuation

A key factor driving NAV is the portfolio valuation. While the number of each kind of security held in the portfolio is beyond doubt, their valuation can be subjective. In order to reduce the subjectivity, and increase the comparability of NAVs across schemes, detailed valuation guidelines have been laid down:

- Wherever a security, say, Infosys share, is traded in the market on the date of valuation, its closing price on that date is taken as the value of the security in the portfolio. Thus, the number of Infosys Shares in the portfolio (say, 1,000) multiplied by its closing price (say, Rs 2,700), gives the valuation of Infosys shares in the portfolio (1,000 shares X Rs 2,700 = Rs 27,00,000). Similarly, every security in the portfolio is to be valued.
- Where equity shares of a company are not traded in the market on a day, or they are thinly traded, a formula is used for the valuation. The valuation formula is based on the Earnings per Share of the company, its Book Value, and the valuation of similar shares in the market (peer group).

- Debt securities that are not traded on the valuation date are valued on the basis of the yield matrix prepared by an authorized valuation agency. The yield matrix estimates the yield for different debt securities based on the credit rating of the security and its maturity profile.
- There are detailed norms on when a security is to be treated as a Non-Performing Asset (NPA), how much is to be written off (treated as a loss) at various points of time, when the amounts written off can be added back to the value of the asset (treated as income), and when a NPA can be treated as a Standard Asset.
- Where an individual security that is not traded or thinly traded, represents more than 5% of the net assets of a scheme, an independent valuer has to be appointed.

6.3 Taxation

6.3.1 Taxability of Mutual Fund

The mutual fund trust is exempt from tax. The trustee company will however pay tax in the normal course on its profits. For example, in the example of SBI Mutual Fund given in Unit 2, SBI Mutual Fund is exempt from tax; SBI Mutual Fund Trustee Company however is liable to tax.

As will be seen, some aspects of taxation of schemes are dependent on the nature of the scheme. The definitions under the Income Tax Act, for the purpose are as follows:

Equity-oriented scheme is a mutual fund scheme where at least 65% of the assets are invested in equity shares of domestic companies. For calculating this percentage, first the average of opening and closing percentage is calculated for each month. Then the average of such value is taken for the 12 months in the financial year.

For *Money market mutual funds / Liquid schemes*, income tax goes by the SEBI definition, which says that such schemes are set up with the objective of investing exclusively in money market instruments (i.e. short term debt securities).

6.3.2 Securities Transaction Tax (STT)

This is a tax on the value of transactions in equity shares, derivatives and equity mutual fund units. Applicability is as follows:

On equity-oriented schemes of mutual funds

| | |
|--|--------|
| On purchase of equity shares in stock exchange | 0.125% |
| On sale of equity shares in stock exchange | 0.125% |
| On sale of futures & options in stock exchange | 0.017% |

On investors in equity oriented schemes of mutual fund

| | |
|--|--------|
| On purchase of the units in stock exchange | 0.125% |
| On sale of the units in stock exchange | 0.125% |
| On re-purchase of units (by AMC) | 0.250% |

STT is not payable on transactions in *debt or debt-oriented* mutual fund units.

6.3.3 Additional Tax on Income Distributed

This is a tax on dividend distributed by debt-oriented mutual fund schemes. Applicability is as follows:

Money Market Mutual Funds / Liquid Schemes:

25% + Surcharge + Education Cess

Other debt funds (investors who are individual / HUF):

12.5% + Surcharge + Education Cess

Other debt funds (other investors):

20% + Surcharge + Education Cess

This additional tax on income distributed (referred to in the market as *dividend distribution tax*) is not payable on dividend distributed by equity-oriented mutual fund schemes.

Dividend distribution tax (DDT) on dividends distributed to corporate investors by all categories of debt funds have been increased to 30%, wef June 1, 2011.

6.3.4 Capital Gains Tax

Capital Gain is the difference between sale price and acquisition cost of the investment. Since mutual funds are exempt from tax, the schemes do not pay a tax on the capital gains they earn.

Investors in mutual fund schemes however need to pay a tax on their capital gains as follows:

Equity-oriented schemes

- Nil – on Long Term Capital Gains (i.e. if investment was held for more than a year) arising out of transactions, where STT has been paid
- 15% plus surcharge plus education cess – on Short Term Capital Gains (i.e. if investment was held for 1 year or less) arising out of transactions, where STT has been paid
- Where STT is not paid, the taxation is similar to debt-oriented schemes

Debt-oriented schemes

- Short Term Capital Gains (i.e. if investment was held for 1 year or less) are added to the income of the investor. Thus, they get

taxed as per the tax slabs applicable. An investor whose income is above that prescribed for 20% taxation would end up bearing tax at 30%. Investors in lower tax slabs would bear tax at lower rates. Thus, what is applicable is the marginal rate of tax of the investor.

- In the case of Long Term Capital Gain (i.e. if investment was held for more than 1 year), investor pays tax at the lower of the following:
 - 10% plus surcharge plus education cess, without indexation
 - 20% plus surcharge plus education cess, with indexation

Indexation means that the cost of acquisition is adjusted upwards to reflect the impact of inflation. The government comes out with an index number for every financial year to facilitate this calculation.

For example, if the investor bought units of a debt-oriented mutual fund scheme at Rs 10 and sold them at Rs 15, after a period of over a year. Assume the government's inflation index number was 400 for the year in which the units were bought; and 440 for the year in which the units were sold. The investor would need to pay tax on the lower of the following:

- 10%, without indexation viz. $10\% \times (\text{Rs } 15 \text{ minus Rs } 10)$ i.e. Rs 0.50 per unit
- 20%, with indexation.

Indexed cost of acquisition is $\text{Rs } 10 \times 440 \div 400$ i.e. Rs11. The capital gains post indexation is Rs 15 minus Rs 11 i.e. Rs 4 per unit. 20% tax on this would mean a tax of Rs 0.80 per unit.

The investor would pay the lower of the two taxes i.e. Rs0.50 per unit.

6.3.5 Tax Deducted at Source (TDS)

There is no TDS on the dividend distribution or re-purchase proceeds to resident investors. However, for certain cases of non-resident investments, with-holding tax is applicable. The income tax regulations prescribe different rates of withholding tax, depending on the nature of the investor (Indian / Foreign and Individual / Institutional), nature of investment (equity / debt) and nature of the income (dividend / capital gain).

Further, Government of India has entered into Double Taxation Avoidance Agreements (DTAA) with several countries. These agreements too, specify rates for Withholding Tax.

The withholding tax applicable for non-resident investors is the lower of the rate specified in the income tax regulations or the tax specified in the DTAA of the country where the investor is resident. The investor, however, will need to satisfy the mutual fund that he is entitled to such concessional rate as is specified in the DTAA.

6.3.6 Taxability of Mutual Fund Investor

Based on the above discussions, it can be summarized that:

- An investor in an equity-oriented mutual fund scheme
 - Would pay STT on the value of the transactions of sale (0.125%) and purchase (0.125%) of units in the stock exchange; or on re-purchase (0.25%) of the units by the AMC
 - Would be exempt from capital gains tax, if the units were held for more than a year
 - Would pay capital gains tax at 15%, if the units were held for 1 year or less
 - Will receive any dividend free of tax; the scheme too will not incur any tax on the dividend distribution.

- An investor in a debt-oriented mutual fund scheme
 - Would not bear any STT
 - Would bear a tax on long term capital gains at the lower of 20% with indexation, or 10% without indexation
 - Would bear a tax on short term capital gains, as per the investor's tax slab.
 - Will receive any dividend free of tax; but the scheme would have paid a tax on the dividend distribution.

6.3.7 Setting off Gains and Losses under Income Tax Act

The Income Tax Act provides for taxation under various heads of income viz. salaries, income from house property, profits & gains of business or profession, capital gains, and income from other sources. In the normal course, one would expect that a loss in one head of income can be adjusted ("set off") against gains in another head of income, since a person is liable to pay tax on the total income for the year. However, there are limitations to such set-off. A few key provisions here are:

- Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries)
- Short term capital loss is to be set off against short term capital gain or long term capital gain
- Long term capital loss can only be set off against long term capital gain
- Since long term capital gains arising out of equity-oriented mutual fund units is exempt from tax, long term capital loss arising out of such transactions is not available for set off.

Several other factors go into taxation or tax exemption. If one is not an expert on the subject, it would be better to engage the services of a tax consultant.

6.3.8 Limitations on Set-off in case of Mutual Fund Dividends

- When a dividend is paid, the NAV (ex-dividend NAV) goes down.

- Dividend is exempt from tax at the hands of investors
- Capital loss may be available for set off against Capital gains.

A potential tax avoidance approach, called *dividend stripping*, worked as follows:

- Investors would buy units, based on advance information that a dividend would be paid.
- They would receive the dividend as a tax-exempt income. Equity schemes, as seen earlier, do not beat the additional tax on income distributed.
- After receiving the dividend, they would sell the units. Since the ex-dividend NAV would be lower, they would book a capital loss (with the intention of setting it off against some other capital gain).

In order to plug this loophole, it is now provided that:

- if, an investor buys units within 3 months prior to the record date for a dividend, and
- sells those units within 9 months after the record date, any capital loss from the transaction would not be allowed to be set off against other capital gains of the investor, up to the value of the dividend income exempted.

Suppose the record date is April 1, 2010, for dividend of Rs 1 per unit for a scheme. Assume an investor buys units at Rs 15 within 3 months prior (i.e. January to March 2010) and sells those units at

Rs 12 within 9 months after the record date (i.e. April to December 2010).

In the normal course, capital loss (short term, because it is held for less than 1 year) of Rs 15 minus Rs 12 i.e. Rs 3 per unit would be available for set off against other capital gain (long term or short term) of the investor. Further, the dividend of Rs 1 would be tax-exempt in the hands of the investor.

On account of the limitations on set-off, the capital loss available for setting off against other capital gain would be restricted to Rs 3 minus Rs 1 i.e. Rs 2 per unit.

In the above case, if the unit-holder wanted the entire capital loss to be available for set off, then either the units should have been bought before Jan 1, 2010, or they should be sold after December 31, 2010. Any intelligent investor knows that it would be better to adopt an investment strategy based on market scenario, and bear the relevant tax, instead of allowing tax optimization to drive the investment strategy.

6.3.9 Limitations on Set-off in case of Bonus Units

Suppose an investor buys units of a scheme at Rs 30. Thereafter, the scheme declares a 1:1 bonus issue i.e. the investor receives 1 new unit, for every unit that was bought earlier. Logically, the NAV of the scheme will halve, and it is likely that the units would now have a value of Rs 15. At this stage, if the investor sells the original units at Rs 15, a loss of Rs 15 is incurred [Rs 30 (original purchase price for the Units) minus Rs 15 (currently realised)].

However, such capital loss is not available for setting off against capital gains, if the original units were bought within a period of 3 months prior to the record date for the bonus issue and sold off within a period of 9 months after the record date.

In such cases, the capital loss will be treated as the cost of acquisition of the bonus units.

6.3.10 Wealth Tax

Investments in mutual fund units are exempt from Wealth Tax.

Multiple Choice Questions

1. Net assets of a scheme is nothing but its investment portfolio
 - a. True
 - b. False

2. The difference between NAV and re-purchase price is
 - a. Entry Load
 - b. Exit Load
 - c. Expense
 - d. Dividend Stripping

3. NAV of income funds is to be calculated upto ___ decimals
 - a. 4
 - b. 3
 - c. 2
 - d. 1

4. Securities Transaction Tax is applicable to Equity Schemes
 - a. True
 - b. False

5. Wealth tax is payable at the applicable rates on equity mutual fund units
- a. True
 - b. False

Answers

1 – b, 2 – b, 3 – a, 4 – a, 5 – b

Checklist of Learning Points

- ☑ The unit-holders' funds in the scheme is commonly referred to as "net assets".
- ☑ Net asset includes the amounts originally invested, the profits booked in the scheme, as well as appreciation in the investment portfolio. It goes up when the market goes up, even if the investments have not been sold.
- ☑ A scheme cannot show better profits by delaying payments. While calculating profits, all the expenses that relate to a period need to be considered, irrespective of whether or not the expense has been paid. In accounting jargon, this is called accrual principle.
- ☑ Similarly, any income that relates to the period will boost profits, irrespective of whether or not it has been actually received in the bank account. This again is in line with the accrual principle.
- ☑ In the market, when people talk of NAV, they refer to the value of each unit of the scheme. Higher the interest, dividend and capital gains earned by the scheme, higher would be the NAV. Higher the appreciation in the investment portfolio, higher would be the NAV.
Lower the expenses, higher would be the NAV.
- ☑ The difference between the NAV and Re-purchase Price is called the "exit load".
- ☑ Schemes can also calibrate the load when investors offer their units for re-purchase. Investors would be incentivized to hold their units longer, by reducing the load as the unit holding period increased. Such structures of load are called "Contingent Deferred Sales Charge (CDSC)
- ☑ SEBI has banned entry loads. So, the Sale Price needs to be the same as NAV. Exit loads / CDSC in excess of 1% of the redemption proceeds have to be credited back to the scheme immediately i.e. they are not available for the AMC to bear selling expenses. Exit load structure needs to be the same for all unit-holders representing a portfolio.

- ☑ Initial issue expenses need to be met by the AMC. There are limits to the recurring expenses that can be charged to the scheme. These are linked to the nature of the scheme and its net assets.
- ☑ Dividends can be paid out of distributable reserves. SEBI has prescribed a conservative approach to its calculation.
- ☑ NAV is to be calculated upto 4 decimal places in the case of index funds, liquid funds and other debt funds. NAV for equity and balanced funds is to be calculated upto at least 2 decimal places.
- ☑ Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.
- ☑ Detailed norms on valuation of debt and equity securities determine the valuation of the portfolio, and therefore the NAV of every scheme.
- ☑ Mutual funds are exempt from tax. However, Securities Transaction Tax (STT) is applicable on investments in equity and equity mutual fund schemes. Additional tax on income distributed (Dividend distribution tax) is applicable on dividends paid by debt mutual fund schemes.
- ☑ Taxability of capital gains, and treatment of capital losses is different between equity and debt schemes, and also between short term and long term. Upto 1 year investment holding is treated as short term.
- ☑ There is no Tax Deducted at Source (TDS) on dividend payments or re-purchase payments to resident investors. Withholding tax is applicable for some non-resident investors.
- ☑ Setting of capital losses against capital gains and other income is subject to limitations to prevent tax avoidance.
- ☑ Investment in mutual fund units is exempt from Wealth Tax.

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Learning Objectives

Who can invest in mutual funds in India? What documentation is required? How do the sale and re-purchase transactions really get implemented? These operational matters are covered in this key Unit for any Distributor.

7.1 Mutual Fund Investors

7.1.1 Eligibility to Invest

The following are eligible to purchase Units of most schemes:

Individual Investors

They invest for their personal benefit or the benefit of their family.

Examples:

- Resident Indian adult individuals, above the age of 18. They can invest, either singly or jointly (not exceeding three names)
- Minors i.e. persons below the age of 18: Since they are not legally eligible to contract, they need to invest through their Parents/ Lawful guardians.
- Hindu Undivided Families (HUFs): Here family members pool the family money (inherited) for investments. The head of the

family (called karta) invests on behalf of the family. Against his name in the application, he would add the letters "HUF" to show that the investment belongs to the family.

- Non-Resident Indians (NRIs) / Persons of Indian origin (PIO) resident abroad. An Indian citizen, who is working abroad, and his / her family residing abroad, are typical NRIs who invest in India. Some Indians go on to become citizens of foreign countries such as US, Canada, New Zealand etc. Since India does not permit dual citizenship, they need to give up their Indian citizenship. However, their status as erstwhile Indians, entitles them to invest in mutual fund schemes on full repatriation or non-repatriation basis. As part of the documentation, they will need to provide their PIO (Person of Indian Origin) Card / OCI (Overseas Citizenship of India) Card.

NRI / PIO resident abroad have the facility of investing on repatriable basis i.e. when they sell the investment, the sale proceeds can be transferred abroad. Alternatively, they can invest on non-repatriable basis, in which case the proceeds from the sale of those investments cannot be remitted abroad. The conditions related to making payments for repatriable investments are discussed later in this unit.

- Foreign investors can invest in equity schemes of MFs registered with SEBI after completing KYC process.
- Non-individual Investors: Here, the individuals who sign the documents are investing on behalf of organizations / institutions they represent, such as:

- Companies / corporate bodies, registered in India
- Registered Societies and Co-operative Societies
- Religious and Charitable Trusts
- Trustees of private trusts
- Partner(s) of Partnership Firms
- Association of Persons or Body of Individuals, whether incorporated or not
- Banks (including Co-operative Banks and Regional Rural Banks) and Financial Institutions and Investment Institutions
- Other Mutual Funds registered with SEBI
- Foreign Institutional Investors (FIIs) registered with SEBI
- International Multilateral Agencies approved by the Government of India
- Army/Navy/Air Force, Para-Military Units and other eligible institutions
- Scientific and Industrial Research Organizations
- Universities and Educational Institutions

The following are not permitted to invest in mutual funds in India:

- An individual who is a foreign national (unless of course, the person is an NRI or PIO / OCI card holder.
- Any entity that is not an Indian resident, as per FEMA (except when the entity is registered as FII with SEBI, or has a sub-account with a SEBI-registered FII).
- Overseas Corporate Bodies (OCBs) i.e. societies / trusts held, directly or indirectly, to the extent of over 60% by NRIs, or trusts where more than 60% of the beneficial interests is held by such OCBs.

7.1.2 Sources of Information on Eligibility

The individual investors eligible to invest as detailed above, can invest in any mutual fund scheme, unless the mutual fund comes out with a specific scheme, or a plan within a scheme, that is not intended for individual investors.

The non-individual investors eligible to invest as detailed above, can invest in a mutual fund. However, it is a good practice to check the 'Who can Invest' section of the Offer Document, especially for a first time investor.

Further, in some schemes, only specific classes of non-individual investors are permitted. For instance:

Some gilt schemes have specific plans, which are open only for Provident Funds, Superannuation and Gratuity Funds, Pension Funds, Religious and Charitable Trusts and Private Trusts.

In the case of Exchange Traded Funds, only authorized participants and large investors can invest in the NFO. Subsequently, in the stock exchange, anyone who is eligible to invest can buy Units of the ETF.

7.2 KYC Requirements for Mutual Fund Investors

Previously it was compulsory for all investments of Rs 50,000 and above to be compliant with the regulatory requirements prescribed under the Anti-Money Laundering Act, 1992 and SEBI circulars in this regard.

The regulations have now been revised. The following investors have to be KYC compliant, irrespective of the investment value:

- Non-individual investors i.e. companies, partnership firms, trusts, HUF etc.
- Non-Resident Indians
- Investors coming through channel distributors

SEBI is keen that investors have unrestricted access to AMCs, and thus ensure that AMCs can execute all financial and non-financial transactions of investors. Therefore, it has been stipulated that:

- c) All new folios/ accounts shall be opened only after ensuring that all investor-related documents including account opening documents, PAN, KYC, PoA (if applicable), specimen signature are available with AMCs/RTAs and not just with the distributor.

- d) For existing folios, AMCs are responsible for updation of the investor related documents including account opening documents, PAN, KYC, PoA (if applicable), specimen signature by November 15, 2010.

Broadly, mutual fund investors need the following documents:

- Proof of Identity
- Proof of Address
- PAN Card
- Photograph

Mutual funds have made an arrangement with CDSL Ventures Ltd (CVL), a wholly owned subsidiary of Central Depository Services (India) Ltd. (CDSL), to make it convenient for mutual fund investors to comply with the documentation requirements. Appendix 5 is CVL's prescribed form for Individuals; Appendix 6 is CVL's prescribed form for non-Individuals.

Select branches / offices of mutual funds, registrars and large distributors serve as Points of Service (PoS) for the KYC documentation. Investors will need to provide the Original, along with a copy of the relevant documents, to any of the PoS (listed in AMFI website – www.amfiindia.com). The Original will be returned after verification. Alternatively, the investor can provide a True Copy attested by a Notary Public, Gazetted Officer or Manager of a Scheduled Commercial Bank.

CVL provides a facility where the PoS, from their own office, can access CVL's system, enter the requisite data and generate an acknowledgement with a Mutual Fund Identification Number (MIN). Based on this acknowledgement, the mutual fund investor can invest in any mutual fund. Thus, the KYC documentation has to be done only ONCE, with CVL acting through the PoS.

Similarly, in the event of change of address or any other information, the mutual fund investor needs to fill the standard form and follow the prescribed process only once, with any of the PoS. Based on that, the information will be updated with all the mutual funds where the investor has invested.

Where investment is made by a minor, KYC requirements have to be complied with by the Guardian.

In the case of investments by a Power of Attorney holder on behalf of an investor, KYC requirements have to be complied with, by both, investor and PoA holder.

7.3 PAN Requirements for Micro-SIPs

PAN Card is compulsory for all mutual fund investments. Exception has been made for Micro-SIPs i.e. SIPs where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000.

Micro-SIP investment by individuals, minors and sole-proprietory firms are exempted from the requirement of PAN card. Instead,

the investors (including joint holders) can submit any one of the following PHOTO IDENTIFICATION documents along with Micro SIP applications:

- Voter Identity Card
- Driving License
- Government / Defense identification card
- Passport
- Photo Ration Card
- Photo Debit Card (Credit card not included because it may not be backed up by a bank account).
- Employee ID cards issued by companies registered with Registrar of Companies)
- Photo Identification issued by Bank Managers of Scheduled Commercial Banks / Gazetted Officer / Elected Representatives to the Legislative Assembly / Parliament
- ID card issued to employees of Scheduled Commercial / State / District Co-operative Banks.
- Senior Citizen / Freedom Fighter ID card issued by Government.
- Cards issued by Universities / deemed Universities or institutes under statutes like ICAI, ICWA, ICSI.

- Permanent Retirement Account No (PRAN) card issued to New Pension System (NPS) subscribers by CRA (NSDL).
- Any other photo ID card issued by Central Government / State Governments /Municipal authorities / Government organizations like ESIC / EPFO.

The Document must be current and valid. Document copy shall be self attested by the investor / attested by the ARN holder mentioning the ARN number.

Investors have to give a declaration stating that the he does not have any existing Micro SIPs which together with the current application will result in aggregate investments exceeding Rs. 50,000 in a year.

It may be noted that the relaxation in documentation requirements for micro-SIPs is not available for HUFs and non-individuals. It is available for NRIs, but not PIOs.

7.4 Additional Documentation Requirements applicable for Institutional Investors

Since institutional investors are not natural persons, authorised individuals invest on behalf of the institution. Therefore, the following additional documents are essential:

- Eligibility for the investing institution to invest. For instance, a company / trust is eligible to invest under the laws of the country, but the company's own incorporation documents (Memorandum of Association and Articles of Association or Trust Deed) may not have provided for such investments. The company / trust cannot invest if its incorporation documents do not provide for investments of this type.

Similarly, in some states, permission of the Charity Commissioner is necessary, before Religious and Charitable Trusts can invest.

- Authorisation for the investing institution to invest. This is typically in the form of a Board Resolution.
- Authorisation for the official to sign the documents on behalf of the investing institution. This again is provided for in the Board Resolution.

These documentation requirements for institutional investors are in addition to the normal KYC documentation, discussed earlier.

7.5 Demat Account

Dematerialisation is a process whereby an investor's holding of investments in physical form (paper), is converted into a digital record. Benefit of holding investments in demat form is that investors' purchase and sale of investments get automatically added or subtracted from their investment demat account, without having to execute cumbersome paperwork. Settlement of most transactions in the stock exchange needs to be compulsorily done in demat form.

The benefits of demat facility for mutual fund investors has increased, with National Stock Exchange and Bombay Stock Exchange making available screen-based platforms for purchase and sale of mutual fund schemes.

The demat facility is typically initiated by the mutual fund, which would tie up with a Depository (like National Securities Depository Ltd or Central Depository Securities Ltd). On the basis of this tie-up, investors can go to a Depository Participant (which is generally a bank or a broking house) and demat their investment holding i.e. convert their physical units into demat units. In order to avail of this facility, the Depository Participant will insist on the investor opening a demat account. Usual KYC documentation will be required.

On dematerialisation, the investor's unit-holding will be added to his / her demat account. As and when the investor sells the unit-holding, the relevant number of units will be reduced from the

investor's demat account. The investor's benefits from a demat account are as follows:

- Less paperwork in buying or selling the Units, and correspondingly, accepting or giving delivery of the Units.
- Direct credit of bonus and rights units that the investor is entitled to, into the investor's demat account.
- Change of address or other details need to be given only to the Depository Participant, instead of separately to every company / mutual fund where the investor has invested.

The investor also has the option to convert the demat units into physical form. This process is called *re-materialisation*.

7.6 Transactions with Mutual Funds

7.6.1 Fresh Purchase

Application forms are available with offices of AMCs, distributors and ISCs. They are also downloadable from the websites of the AMCs concerned.

The normal application form, with KIM attached, is designed for fresh purchases i.e. instances where the investor does not have an investment account (technically called "*folio*") with the specific mutual fund. The mutual fund would need the application form with the prescribed documentation and the requisite investment amount, to allot an investment folio in the name of the investor.

While investing, the investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for the scheme.

7.6.2 Additional Purchases

Once an investor has a folio with a mutual fund, subsequent investments with the same mutual fund do not call for the full application form and documentation. Only transaction slip needs to be filled, and submitted with the requisite payment. The transaction slip can be similarly used in the event of change in any information e.g. address of investor.

Most mutual funds send a transaction slip (with the investor's folio number pre-printed) along with the Statement of Account. Alternatively, blank transaction slip (without pre-printed folio number), which is available with branches of the AMC, distributors and ISCs, or downloadable from the net, can be used.

The investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for additional purchases in the scheme.

7.6.3 Online Transactions

This facility is given to an existing investor in a mutual fund. The investor is required to fill the requisite details in an application form. Based on this, the registrar would allot a user name and password (Personal Identification Number – PIN). This can be used by the investor to make further purchases of units in the

mutual fund, or to request re-purchase of the units held in the mutual fund.

Some distributors too, through their websites, facilitate online transactions by investors.

7.6.4 Payment Mechanism for purchase / additional purchase

Mutual funds do not accept cash. Application moneys need to come through normal banking channels, as detailed below

Cheque / Demand Draft (DD) – Application forms for fresh investment / transaction slip for additional purchase is normally accompanied by one of these instruments, drawn in favour of the scheme in which application is to be made.

Cheques are signed by the account holder, while DDs are signed by the banker. Generally, DDs are accepted only if the investor is from outside the location where the application form / transaction slip is being submitted.

NRI / PIO applications need to be accompanied by cheque drawn on an NRO account (for non-repatriable investment) or NRE account (for repatriable investment). If payment from NRI is by DD, and investment is on repatriable basis, a banker's certificate will be required to the effect that the DD has come out of moneys remitted from abroad. When the NRI receives money in his bank account in India, the banker would issue a Foreign Inward Remittance Certificate (FIRC), which is evidence that the money was remitted from abroad.

The payment instrument would need to be local i.e.

Cheque should be drawn on a local bank account. If it is drawn on an out-station bank account, then the bank should offer the facility of 'at par' payment in the location where the application form and cheque are submitted. If such an 'at par' facility is available, 'payable at par at (list of locations / all over India)' would be clearly mentioned in the face or back of the cheque. Cheques accompanying the investment application are to be signed by the investor. Third-party cheques are not accepted except in special cases such as grandparents/parents making payments not exceeding Rs.50,000 on behalf of a minor, employer making payments on behalf of employee through payroll deductions and custodian on behalf of FIIs. AMCs are required to put checks and balances in place to verify such transactions.

Similarly, DD should clearly mention the place of payment as the location where the application form / transaction slip and payment instrument are being submitted.

The payment instrument should not be post-dated (except for future instalments under SIP), and not stale (i.e. cheque date should not be more than 6 months older than the date on which the cheque is to be banked).

Remittance can also be made directly to the bank account of the scheme through Real Time Gross Settlement (RTGS) / National Electronic Funds Transfer (NEFT) transfers (for transfers within India) or SWIFT transfer (for transfers from abroad). While RTGS transfers are instantaneous, NEFT transfers are batched together

in the banking system, and effected at various times during the day. SWIFT transfers tend to pass through multiple banks in different geographies, and multiple levels within the same bank, resulting in delays.

Before money is remitted directly to the mutual fund, it is advisable to get the proper bank account details from the AMC / distributor. Further, the application form / transaction slip will need to be accompanied by proof of the remittance.

Electronic Clearing Service (ECS) / Standing Instructions are a convenient form of investment in a SIP. On the specified date, each month, the bank will automatically transfer money from the investor's account to the account of the mutual fund. The bank accepts 'Standing Instructions' (also called 'Direct Debit') if both investor and mutual fund have an account with the same bank. If the two accounts are in different bank, then ECS is used.

Application Supported by Blocked Amount (ASBA) – This is a facility where the investment application is accompanied by an authorization to the bank to block the amount of the application money in the investor's bank account.

The benefit of ASBA is that the money goes out of the investor's bank account only on allotment. Until then, it keeps earning interest for the investor. Further, since the money transferred from the investor's bank account is the exact application money that is due on account of the allotment, the investor does not have to wait for any refund.

ASBA, which was originally envisaged for public issues in the capital market, has now been extended to mutual fund NFOs.

M-Banking is nascent in India. RBI has permitted banks to offer the facility of transferring upto Rs 50,000 per customer per day, through the mobile connection. Once people are comfortable with M-banking, this will become a convenient way to invest.

7.6.5 Allotment of Units to the Investor

Since entry load is banned, units in an NFO are sold at the face value i.e. Rs 10. So the investment amount divided by Rs 10 would give the number of units the investor has bought.

The price at which units are sold to an investor as part of ongoing sales in an open-end scheme is the sale price, which in turn is the applicable NAV (which is discussed later in this unit under 'Cut-off Time') plus Entry Load (currently entry load is not permitted by regulation).

The investment amount divided by the sale price would give the number of units the investor has bought.

Thus, an investor who has invested Rs 12,000, in a scheme where the applicable sale price is Rs 12, will be allotted $\text{Rs } 12,000 \div \text{Rs } 12$ i.e. 1,000 units.

In a rights issue, the price at which the units are offered i.e. the rights price is clear at the time of investment. The investment amount divided by the rights price gives the number of units that the investor has bought.

It may however be noted that rights issues, which are common for shares, are less meaningful for units of mutual fund schemes.

In a bonus issue, the investor does not pay anything. The fund allots new units for free. Thus, in a 1:3 bonus issue, the investor is allotted 1 new unit (free) for every 3 units already held by the investor. Since the net assets of the scheme remain the same – only the number of units increases - the NAV will get reduced proportionately.

7.6.6 Repurchase of Units

The investor in an open ended scheme can offer the units for repurchase to the mutual fund. The transaction slip would need to be filled out to effect the re-purchase. Investor has the option to decide on the repurchase amount (which is generally the case) or number of units offered for re-purchase. The re-purchase price is the applicable NAV (which is discussed later in this unit under 'Cut-off Time') less Exit Load.

If the investor has specified the re-purchase amount, then that amount divided by the re-purchase price would be the number of units that will be reduced from his folio.

If the investor has specified the re-purchase units, then those many units will be reduced from his folio; payment would be made equivalent to the number of units re-purchased, multiplied by the re-purchase price.

If, while effecting the re-purchase, the investment holding in the folio goes below the minimum limit set by the mutual fund for the

scheme, then all the Units may be re-purchased and the investment folio of the investor would be closed.

7.6.7 Payment Mechanism for Repurchase of Units

The investor has various options for receiving the moneys, due to him from the scheme on re-purchase of Units:

Cheque – This is a traditional approach, where the receipt of money in the investor’s bank account is delayed on account of the processes involved viz. time taken by the AMC to prepare and send the cheque, time taken by postal authorities / courier to deliver the cheque, time taken by the investor to deposit the cheque in the bank, and time taken by the banking system to transfer the proceeds to the investor’s bank account.

Direct Credit – The investor can give instructions for the repurchase proceeds to be directly transferred to his bank account. This is much faster because the various processes mentioned earlier for payment by cheque, are obviated.

It may be noted that for non-resident investors, payment is made by the AMC in rupees. In case the investment has been made on repatriable basis, and the investor wishes to transfer the moneys abroad, the costs associated with converting the rupees into any foreign currency would be to the account of the investor.

7.6.8 Cut-off Time

As seen earlier, the sale and re-purchase prices are a function of the applicable NAV. In order to ensure fairness to investors, SEBI has prescribed cut-off timing to determine the applicable NAV.

The provisions, which are uniformly applicable for all mutual funds, are as follows:

| Scheme Type | Transaction | Cut-off Time | Applicable NAV |
|---|-------------|---------------------|--|
| Liquid (if funds are available for utilisation on same day) | Sale | Received upto 2 PM | Closing NAV of Day immediately preceding the date of application |
| Liquid (if funds are available for utilisation on same day) | Sale | Received after 2 PM | Closing NAV of Day immediately preceding next business day |
| Liquid (if funds | Sale | Received | Closing NAV |

| Scheme Type | Transaction | Cut-off Time | Applicable NAV |
|---|-------------|----------------------------------|---|
| are NOT available for utilisation on same day) | | any time during the day | of Day preceding the day on which funds are available for utilization |
| Liquid Schemes | Re-purchase | Received before 3 pm | Closing NAV of Day preceding next business day |
| Liquid Schemes | Re-purchase | Received after 3 pm | Closing NAV of next business day |
| Schemes other than Liquid Schemes (investment of Rs 1 crore or above) | Sale | Received any time during the day | Closing NAV of day funds are available for utilisation |

| Scheme Type | Transaction | Cut-off Time | Applicable NAV |
|--|-------------|---|--|
| Schemes other than Liquid Schemes (investment upto Rs 1 crore) | Sale | Application received upto 3 pm with local cheque / DD | Closing NAV of date application is received |
| Schemes other than Liquid Schemes (investment upto Rs1crore) | Sale | Application received after 3 pm with local cheque / DD | Closing NAV of next business day |
| Schemes other than Liquid Schemes (investment upto Rs1crore) | Sale | Application received with outstation cheque / DD (irrespective of time) | Closing NAV of day the cheque / DD is credited in the bank account |

| Scheme Type | Transaction | Cut-off Time | Applicable NAV |
|-----------------------------------|-------------|---------------------------------|----------------------------------|
| Schemes other than Liquid Schemes | Re-purchase | Application received upto 3 pm | Closing NAV of same day |
| Schemes other than Liquid Schemes | Re-purchase | Application received after 3 pm | Closing NAV of next business day |

The applicable NAV for switch-in transactions to liquid funds is the NAV of the day preceding the day of application provided

- The application is received before cut-off time
- Funds credited to the scheme's account before cut-off time
- Funds available for utilization without using any credit facilities

The above cut-off timing is not applicable for NFOs and International Schemes.

7.6.9 Time Stamping

The precision in setting cut-off timing make sense only if there is a fool proof mechanism of capturing the time at which the sale and re-purchase applications are received. This is ensured through the following:

Mutual funds disclose official Points of Acceptance (PoAs) and their addresses in the SID and their website. All transaction requests need to be submitted at the POAs.

As a convenience, the distributor may accept the transaction request from the investor, but this would need to be sent to a PoA at the earliest. When the cut-off timing is applied, the time when it is submitted to the PoA is relevant – not the time when the investor submits the transaction request to the distributor.

These points of acceptance have time stamping machines with tamper-proof seal. Opening the machine for repairs or maintenance is permitted only by vendors or nominated persons of the mutual fund. Such opening of the machine has to be properly documented and reported to the Trustees.

Applications are sequentially numbered from the first number of the machine to the last number of the machine, before a new numbering cycle is started for the machine.

Application for purchase of units is stamped with automatically generated location code, machine identifier, serial number, date and time; the reverse of the payment instrument has to be similarly

stamped with the same number; the acknowledgement issued to the investor gets a similar stamp.

Application for re-purchase and investor's acknowledgement are stamped with the same information.

Similarly applications for non-financial transactions like change of address, and investor's acknowledgement are stamped. However, here stamping of time is not relevant; the data stamping is pertinent.

For online transactions, the time as per the web server to which the instruction goes, is used in determining the NAV for sale / re-purchase transactions.

7.7 Transactions through the Stock Exchange

Both National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) have extended their trading platform to help the stock exchange brokers become a channel for investors to transact in Mutual Fund Units. NSE's platform is called NEAT MFSS. BSE's platform is BSE StAR Mutual Funds Platform.

Both platforms are open from 9 am to 3 pm on every working day. Fresh subscriptions in a mutual fund, as well as additional purchases are possible. Similarly, redemptions are permitted. Each of these transactions may be in physical form or demat form.

Redemption requests can be given in number of units. Transactions are otherwise entered in the system based on proposed value of purchase or redemption.

The transaction slip generated by the broking system, also includes the time stamp. This serves the purpose of an acknowledgement for the investor.

The stock exchanges, together with their clearing corporation, handle the first leg of the transaction, viz. investor's subscription or re-purchase request. If these are in physical form, the stock exchange broker would need to arrange to send the documents to the nearest RTA.

The second leg of the transaction viz. sending units against investors' subscription, or sending money against the re-purchase request, is the responsibility of the RTA.

Since this is essentially an order routing system between the investors and the AMC, the exchanges do not offer Settlement Guarantee. Responsibility for settlement is that of the AMC. However, the normal stock exchange redressal mechanism would be available to address any investor complaints.

7.8 Investment Plans and Services

7.8.1 Dividend Payout, Growth and Dividend Re-Investment Options

Most mutual fund schemes offer two options – Dividend and Growth. A third option which is possible is the Dividend re-investment Option. These are different options within a scheme; they share the same portfolio. Therefore the portfolio returns are the same for all three options. However, they differ in the structure of cash flows and income accruals for the unit-holder, and therefore, the Unit-holder's taxability, number of units held and value of those units.

In a dividend payout option, the fund declares a dividend from time to time. Some schemes even declare a dividend daily, subject to availability of profits. As was seen in Unit 6:

- When a dividend is paid, the NAV of the units falls to that extent.
- Debt schemes need to pay an income distribution tax on the dividend distributed. This tax payment too reduces the NAV.

The reduced NAV, after a dividend payout is called ex-Dividend NAV. After a dividend is announced, and until it is paid out, it is referred to as cum-Dividend NAV.

In a dividend payout option, the investor receives the dividend in his bank account; the NAV goes down to reflect the impact of the dividend paid, and, if applicable, the income distribution tax.

However, the dividend payout does not change the number of units held by the investor.

The dividend received in the hands of the investor does not bear any tax.

In a dividend re-investment option, as in the case of dividend payout option, NAV declines to the extent of dividend and income distribution tax. The resulting NAV is called ex-dividend NAV.

However, the investor does not receive the dividend in his bank account; the amount is re-invested in the same scheme. Thus, if dividend is Rs 2 per unit on a Unit-holder's 100 units, the dividend would amount to Rs 200. Assuming the ex-dividend NAV of the scheme is Rs 20, $\text{Rs } 200 \div \text{Rs } 20$ i.e. 10 units will be added to the unit-holder's portfolio.

Dividend is not declared in a growth option. Therefore, nothing is received in the bank account (unlike dividend payout option) and there is nothing to re-invest (unlike dividend re-investment option). In the absence of dividend, there is no question of income distribution tax. The NAV would therefore capture the full value of portfolio gains.

As in the case of dividend payout option, there will be no accretion to the number of units held; the NAV of those Units will however be higher, to reflect the gain in the portfolio.

Across the 3 options, the investor can also receive money by offering his units for re-purchase or selling them in the stock

market. Taxability would depend on the scheme type and period of holding, as was discussed in Unit 6.

In summary, the implication of the 3 options, is as follows:

| Parameter | Dividend Payout Option | Dividend Re-investment Option | Growth Option |
|--|---|---|-----------------------------------|
| <i>Dividend received in bank account</i> | Yes | No | No |
| <i>Income Distribution Tax</i> | Yes, for debt schemes | Yes, for debt schemes | No |
| <i>Increase in number of units on account of re-investment of dividend</i> | No | Yes | No |
| <i>NAV change</i> | NAV declines to the extent of dividend and income | NAV declines to the extent of dividend and income | NAV captures the portfolio change |

| Parameter | Dividend Payout Option | Dividend Re-investment Option | Growth Option |
|-----------|------------------------|-------------------------------|---------------|
| | distribution tax | distribution tax | entirely |

7.8.2 Systematic Investment Plan (SIP)

It is considered a good practice to invest regularly. SIP is an approach where the investor invests constant amounts at regular intervals. A benefit of such an approach, particularly in equity schemes, is that it averages the unit-holder's cost of acquisition.

Suppose an investor were to invest Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor will be allotted $\text{Rs } 1,000 \div \text{Rs } 10$ i.e. 100 units. In the second month, if the NAV has gone up to Rs 12, the allotment of units will go down to $\text{Rs } 1,000 \div \text{Rs } 12$ i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be allotted a higher number of $\text{Rs } 1,000 \div \text{Rs } 9$ i.e. 111.111 units.

Thus, the investor acquires his Units closer to the average of the NAV on the 6 transaction dates during the 6 month period – a reason why this approach is also called *Rupee Cost Averaging*. Through an SIP, the investor does not end up in the unfortunate

position of acquiring all the units in a market peak. Mutual funds make it convenient for investors to lock into SIPs by investing through Post-Dated Cheques (PDCs), ECS or standing instructions.

7.8.3 Systematic Withdrawal Plan

Just as investors do not want to buy all their units at a market peak, they do not want all their units redeemed in a market trough. Investors can therefore opt for the safer route of offering for re-purchase, a constant value of units.

Suppose an investor were to offer for re-purchase Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor's unit-holding will be reduced by $\text{Rs } 1,000 \div \text{Rs } 10$ i.e. 100 units. In the second month, if the NAV has gone up to Rs 12, the unit-holding will go down by fewer units viz. $\text{Rs } 1,000 \div \text{Rs } 12$ i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be offering for re-purchase a higher number of units viz. $\text{Rs } 1,000 \div \text{Rs } 9$ i.e. 111.111 units. Thus, the investor re-purchases his Units at an average NAV during the 6 month period. The investor does not end up in the unfortunate position of exiting all the units in a market trough.

Mutual funds make it convenient for investors to manage their SWPs by indicating the amount, periodicity (generally, monthly) and period for their SWP. Some schemes even offer the facility of transferring only the appreciation or the dividend. Accordingly, the mutual fund will re-purchase the appropriate number of units of the

unit-holder, without the formality of having to give a re-purchase instruction for each transaction.

An investor may opt for SWP for several reasons:

- As discussed earlier, minimise the risk of redeeming all the units during a market trough.
- Meet liquidity needs for regular expenses.
- Assuming the scheme is profitable, the re-purchase ensures that some of the profits are being regularly encashed by the investor.
- As discussed under Taxation, debt schemes are subject to Income Distribution Tax. In such schemes, it would be more tax-efficient to take money out of the scheme as a re-purchase (on which there is no income distribution tax) as compared to dividend (which would be liable to income distribution tax).

7.8.4 Systematic Transfer Plan

This is a variation of SWP. While in a SWP the constant amount is paid to the investor at the pre-specified frequency, in a STP, the amount which is withdrawn from a scheme is re-invested in some other scheme of the same mutual fund. Thus, it operates as a SWP from the first scheme, and a SIP into the second scheme. Since the investor is effectively switching between schemes, it is also called "switch". If the unit-holder were to do this SWP and SIP as separate transactions-

- The Unit-holder ends up waiting for funds during the time period that it takes to receive the re-purchase proceeds, and has idle funds, during the time it takes to re-invest in the second scheme. During this period, the market movements can be adverse for the unit-holder.
- The Unit-holder has to do two sets of paper work (Sale and Re-purchase) for every period.

The STP offered by mutual funds is a cost-effective and convenient facility.

7.8.5 Triggers

It is not uncommon for investors to rue missed opportunities of buying or selling because they could not give the requisite instructions in time. This is addressed through the trigger option that is available for some schemes.

For instance, an investor can specify that the Units would be re-purchased if the market reaches a particular level. In that case, once the market reaches that level, the Units would be re-purchased, without the need for going through a separate re-purchase documentation. It stands to reason that if the market continues to go up after the trigger is auctioned, the investor loses on the further gain.

Similarly, an investor can set a trigger to transfer moneys into an equity scheme when the market goes down, say, 20%. This would help the investor conveniently increase his position in equities, when the market goes down 20%.

Investors should study the conditionalities attached to trigger options (and any value added service), because these vary from scheme to scheme.

7.8.6 Statement of Account and Investment Certificate

The time limit within which these need to be issued was discussed in Unit 3. The Statement of Account shows for each transaction (sale / re-purchase), the value of the transaction, the relevant NAV and the number of units transacted. Besides, it also provides the closing balance of units held in that folio, and the value of those units based on the latest NAV.

7.8.7 Nomination

Most investors like clarity about what would happen to their unit-holding, in the unfortunate event of their demise. This clarity can be achieved by executing a Nomination Form, where the nominee's name is specified. If the nominee is a minor, then a guardian too can be specified. In the case of joint holding, every unit-holder will have to sign the nomination form.

If one joint holder dies, then the Units will continue to be held by the surviving joint holder/s. If the sole Unit-holder or all joint holders die/s, then the Units will be transferred to the nominee. Before the transfer is effected, the mutual fund will insist on the KYC documentation from the nominee, death certificate/s of the deceased, and an indemnity against future problems for the mutual fund arising out of the transfer.

It would be pertinent to note here that nomination is only an authorization for the mutual fund to transfer the units to the nominee in the event of demise of the unit-holder. The inheritance laws applicable to the unit-holder too need to be considered by the investor. Professional advice on inheritance issues and preparation of a Will are strongly advised.

7.8.8 Pledge

Banks, NBFCs and other financiers often lend money against pledge of Units by the Unit-holder. This is effected through a *Pledge Form* executed by the unit-holder/s (*pledger/s*). The form has a provision for specifying the party in whose favour the Units are pledged (*pledgee*).

Once Units are pledged, the Unit-holder/s cannot sell or transfer the pledged units, until the pledger gives a no-objection to release the pledge.

7.8.9 Other Services

AMCs (and also some distributors) offer various other services for investors. Some of these are as follows:

- Online access to information on investments, including consolidated view of various folios that relate to different family members.
- Daily NAV and other key developments transmitted through SMS / E-mail.

- Sharing of information on portfolio valuation, income booked, returns earned, capital gains working for income tax purposes etc.

KYC Form for Non-Individuals

Know Your Client (KYC)
Application Form

(For Non-Individuals Only)

Application No. :

Please fill in ENGLISH and in BLOCK LETTERS (All information as applicable in Sections A, B and C below is mandatory) The information is sought under Prevention of Money Laundering Act, 2002, the rules notified thereunder and SEBI's guidelines on Anti Money Laundering for existing Mutual Fund investors, the address(es) furnished herein will be replaced in the records of the Mutual Fund / Authorised Agent. (Refer Notes / Guidelines overlaid)

A. Identity Details (Please see guidelines A1 to A4 overlaid)

| | | | | | | | | | |
|---|--|--|---|--|---|--|---|--|--|
| 1. Name of Applicant (Please write complete name as per Certificate of Incorporation / Registration; leaving one box blank between 2 words. Please do not abbreviate the Name). | | | | | | | | | |
| 2. Date of Incorporation / Registration | | D | / | M | / | Y | Y | Whether Listed on MSE | |
| | | | | | | | | <input type="checkbox"/> YES <input type="checkbox"/> NO Scrp Symbol | |
| Registration Number issued by Registering Authority | | | | | | | | | |
| 3. Status Please tick (✓) | | <input type="checkbox"/> Company | | <input type="checkbox"/> Body Corporate | | <input type="checkbox"/> Partnership | | <input type="checkbox"/> Trust | |
| | | <input type="checkbox"/> Non-Government Organisation | | <input type="checkbox"/> Defence Establishment | | <input type="checkbox"/> Body of Individuals | | <input type="checkbox"/> Society | |
| 4. Permanent Account Number (PAN) (MANDATORY) | | | | | | | | | |
| | | <input type="checkbox"/> Copy of PAN Card attached | | | | | | | |

B. Address Details (Please see guidelines B1 to B3 overlaid)

| | | | | | | | | | | |
|--|-----------|---------|-------------|-------------------|-------|-------|--|--|--|--|
| 1. Address for Correspondence | | | | | | | | | | |
| City / Town / Village | State | Country | Postal Code | | | | | | | |
| 2. Contact Details | | | | | | | | | | |
| Contact Person | Mr. / Ms. | | | Tel. (Res.) (STD) | (STD) | | | | | |
| | | | | Fax | (STD) | (STD) | | | | |
| 3. Permanent / Registered Address of Applicant (in case of Overseas Address, Proof of Address is a must) - Mandatory for FIs | | | | | | | | | | |
| City / Town / Village | State | Country | Postal Code | | | | | | | |

C. Other Details (Please see guidelines C1 and C2 overleaf)

- 1. Gross Annual Income Details** Please tick (✓)
- Up to Rs. 50,000 Rs. 50,00,001 to Rs. 2,50,00,000 Rs. 2,50,00,001 to Rs. 10,00,00,000 Rs. 10,00,00,001 to Rs. 50,00,00,000 Rs. 50,00,00,001 and above.
- 2. Mandatory Certified Documents to be submitted, as applicable (Please tick (✓) against documents attached)**
- i. **Hindu Undivided Family (HUF)**
 Deed of Declaration Latest Bank Passbook / Latest Bank account statement
- ii. **Company / Body Corporates**
 Certificate of Incorporation Memorandum & Articles of Association Resolution of the Board of Directors
 Authorised Signatory List with specimen signatures
- iii. **Partnership firms**
 Certificate of registration Partnership deed Documents evidencing authority to invest
 Authorised Signatory List with specimen signatures
- iv. **Trusts, foundations, NGOs, Charitable Bodies, Clubs / Mutual Fund Schemes**
 Certificate of registration Trust deed Authorised Signatory List with specimen signatures
- v. **Unincorporated association or a body of individuals**
 Proof of Existence / Constitution Document Documents evidencing authority to invest
 Authorised Signatory List with specimen signature
- vi. **Foreign Institutional Investors (FIIs)**
 Letter and Certificate of Registration issued by SEBI Authorised Signatory list with specimen signature
- vii. **Scheduled Commercial Banks and Registered Financial Institutions not incorporated under the Companies Act, 1956 / Regulatory Bodies / Army / Government Bodies / Any other bodies created / incorporated / registered under state or central legislation being eligible to invest in Mutual Funds**
 Copy of Constitution / registration documents Documents evidencing authority to invest
 List of authorized signatories

DECLARATION

We hereby confirm that we have read and understood the instructions mentioned overleaf and apply to CDSL Ventures Limited (CVL) or other agent of the mutual fund registered under the SEBI (Mutual Funds) Regulations, 1996 for compliance of Know Your Client (KYC) procedure for transacting in units issued by Mutual Funds and we agree to abide by the terms, conditions, rules, regulations and other statutory requirements applicable to the respective Mutual Funds. We hereby declare that the particulars given herein are true, correct and complete to the best of our knowledge and belief, the documents submitted along with this application are genuine and we are not making this application for the purpose of contravention of any Act, Rules, Regulations or any statute or legislation or any Notifications, Directions issued by any governmental or statutory authority from time to time. We hereby undertake to promptly inform CVL / the mutual fund agent of any changes to the information provided hereinabove and agree and accept that CVL, the respective Mutual Funds, their authorised agents and representatives, (the Authorised Parties) are not liable or responsible for any losses, costs, damages arising out of any actions undertaken or activities performed by them on the basis of the information provided by us as also due to us not intimating / delay in intimating such changes. We hereby authorize CVL / the mutual fund agent to disclose, share, remit in any form, mode or manner, all / any of the information provided by us to the respective Mutual Funds in which we may transact / have transacted and / or to their authorised agents and representatives including all changes, updates to such information as and when provided by us. We hereby agree to provide any additional information / documentation that may be required by the Authorised Parties, in connection with this application.

SIGNATURE(S) OF AUTHORISED PERSON(S)

Place : _____
 Date : _____

For Office Use Only

Stamp of POS
 (Name & Location)
 & Receiver's Signature

(Originals Verified) Self Certified Document copies received
 (Attested) True copies of documents received

Name and Employee Number of Receiver

KYC Ref.

Multiple Choice Questions

1. Foreign nationals are freely permitted to invest in Indian mutual funds
 - a. True
 - b. False
2. PAN Card is compulsory for all mutual fund investments above Rs 50,000, including SIPs
 - a. True
 - b. False
3. Investments in mutual fund can be made using
 - a. Cheque / DD
 - b. Remittance
 - c. ASBA
 - d. Any of the above
4. Cut-off timing guidelines are not applicable for
 - a. NFOs
 - b. International Funds

- c. Both the above
 - d. None of the above
5. STP is a combination of SIP and SWP
- a. True
 - b. False

Answers

1 – b, 2 – a, 3 – d, 4 – c, 5 – a

Checklist of Learning Points

- ☑ Individual and non-individual investors are permitted to invest in mutual funds in India. Foreign nationals, foreign entities and OCBs are not permitted to invest. Since FIIs are permitted to invest, foreign entities can take this route. The 'Who can invest' section of the Offer Document is the best source to check on eligibility to invest.
- ☑ All investments of Rs 50,000 and above need to comply with KYC documentation viz. Proof of Identity, Proof of Address, PAN Card and Photograph. Once an investor obtains a Mutual Fund Identification Number (MIN) from CDSL Ventures Ltd, the investor can apply with any mutual fund.
- ☑ Micro SIPs i.e. SIPs with annual investment below Rs 50,000 is exempted from the PAN Card requirement. Simplified documentation has been prescribed in such cases.
- ☑ Besides KYC, non-individual investors need to provide additional documentation to support their investment.
- ☑ Demat makes it possible to trade in Units in the stock exchange.
- ☑ Full application form is to be filled for a first time investment in a mutual fund. Thereafter, additional investments in the same mutual fund are simpler. Only transaction slip would need to be filled.
- ☑ Investors can pay for their Unit purchases through cheque / DD, Net-based remittances, ECS / Standing Instructions or ASBA. M-Banking is likely to increase in importance in the days to come. Non-resident investment on repatriation basis has to be paid through cheque on NRE account, or a banker's certificate that investment is made out of moneys remitted from abroad.
- ☑ Transaction Slip can be used for re-purchase. Investors can indicate the amount to re-purchase or the number of units to re-purchase.
- ☑ Cut-off timings have been specified for different types of schemes and different contexts to determine the applicable NAV for sale

and re-purchase transactions. These are not applicable for NFOs and International Schemes.

- ☑ Time Stamping is a mechanism to ensure that the cut-off timing is strictly followed.
 - ☑ NSE's platform is called NEAT MFSS. BSE's platform is BSE StAR Mutual Funds Platform.
 - ☑ Dividend payout, Dividend investment and Growth are 3 possible options within a scheme. Each option has different implications on the investor's bank account, investor's taxation and scheme NAV.
 - ☑ A constant amount is regularly invested in SIP, withdrawn in SWP and transferred between schemes in STP. These minimize the risk of timing the decisions wrongly.
 - ☑ Triggers are another way of bring discipline into investing.
 - ☑ Nomination and Pledge options are available for mutual fund investors.
-

8. Return, Risk & Performance of Funds

Learning Objectives

This unit is an invaluable guide to understanding the risk and return aspects of mutual fund schemes. Here, you will understand the nitty-gritty of how to calculate the returns from a mutual fund, and gain an overview of how risk can be measured. Benchmarking and risk adjusted returns are other key concepts discussed in this unit.

Matching of schemes with different kinds of investors is however covered in the next unit.

8.1 Drivers of Returns in a Scheme

The portfolio is the main driver of returns in a mutual fund scheme. The underlying factors are different for each asset class.

8.1.1 Equity Schemes

Securities Analysis Disciplines – Fundamental Analysis and Technical Analysis

These are quantitative approaches to securities analysis. As will be appreciated, a passive fund maintains a portfolio that is in line with the index it mirrors. Therefore, a passive fund manager does not need to go through this process of securities analysis. But

securities analysis is an important aspect of actively managed schemes.

Fundamental Analysis entails review of the company's fundamentals viz. financial statements, quality of management, competitive position in its product / service market etc. The analyst sets price targets, based on financial parameters like

Earnings per Share (EPS): $\text{Net profit after tax} \div \text{No. of equity shares}$

This tells investors how much profit the company earned for each equity share that they own.

Price to Earnings Ratio (P/E Ratio): $\text{Market Price} \div \text{EPS}$

When investors buy shares of a company, they are essentially buying into its future earnings. P/E ratio indicates how much investors in the share market are prepared to pay (to become owners of the company), in relation to the company's earnings. This ratio is normally calculated based on a projected EPS for a future period (also called *forward EPS*)

A simplistic (but faulty) view is that low P/E means that a share is cheap, and therefore should be bought; the corollary being that high P/E means that a share is expensive, and therefore should be sold. In reality, the P/E may be high because the company's prospects are indeed good, while another company's P/E may be low because it is unlikely to replicate its past performance.

Book Value per Share: $\text{Net Worth} \div \text{No. of equity shares}$

This is an indicator of how much each share is worth, as per the company's own books of accounts. The accounts represent a historical perspective, and are a function of various accounting policies adopted by the company.

Price to Book Value: $\text{Market Price} \div \text{Book Value per Share}$

An indicator of how much the share market is prepared to pay for each share of the company, as compared to its book value.

Such financial parameters are compared across companies, normally within a sector. Accordingly, recommendations are made to buy / hold / sell the shares of the company.

As in the case of P/E ratio, most financial indicators cannot be viewed as stand-alone numbers. They need to be viewed in the context of unique factors underlying each company. The fundamental analyst keeps track of various companies in a sector, and the uniqueness of each company, to ensure that various financial indicators are understood in the right perspective.

The discipline of Technical Analysis has a completely different approach. Technical Analysts believe that price behaviour of a share, and the volumes traded are a reflection of investor sentiment, which in turn will influence future price of the share. Technical Analysts therefore study price-volume charts (a reason for their frequently used description as "*chartists*") of the company's shares to decide support levels, resistance levels, break outs etc.

Both types of analysts swear by their discipline. It is generally agreed that longer term investment decisions are best taken through a fundamental analysis approach, while technical analysis comes in handy for shorter term speculative decisions, including intra-day trading. Even where a fundamental analysis-based decision has been taken on a stock, technical analysis might help decide when to implement the decision i.e. the timing.

Investment Styles – Growth and Value

Growth investment style entails investing in high growth stocks i.e. stocks of companies that are likely to grow much faster than the economy. Many market players are interested in accumulating such *growth stocks*. Therefore, valuation of these stocks tends to be on the higher side. Further, in the event of a market correction, these stocks tend to decline more.

Value investment style is an approach of picking up stocks which are valued lower, based on fundamental analysis. The belief is that the market has not appreciated some aspect of the value in a company's share – and hence it is cheap. When the market recognizes the intrinsic value, then the price would shoot up. Such stocks are also called *value stocks*.

Since no time frame can be set for the market to recognize the value, value stocks tend to be longer term investments, at times beyond two years. Even then, the market may not recognize it, in which case the investment fails. However, because the shares have been bought early, and at lower valuations, the losses arising out of a failed decision are lesser.

Value investors maintain a portfolio of such value stocks. In the stocks where their decision is proved right, they earn very high returns, which more than offset the losses on failed decisions.

It is important to note that 'high valuation' is not the equivalent of 'high share price', just as 'low valuation' is not the same as 'low share price'. Fundamental analysts look at value in the context of some aspect of the company's financials. For example, how much is the share price as compared to its earnings per share (*Price to Earnings Ratio*); or how much is the share price as compared to its book value (*Price to Book Value Ratio*).

Thus, a company's share price may be high, say Rs 100, but still reasonably valued given its earnings; similarly, a company may be seen as over-valued, even when its share price is Rs 5, if it is not matched by a reasonably level of earnings.

Investments of a scheme can thus be based on growth, value or a blend of the two styles. In the initial phases of a bull run, growth stocks deliver good returns. Subsequently, when the market heats up, value picks end up being safer.

Portfolio building approach – Top down and Bottom up

In a *top down* approach, the portfolio manager decides how to distribute the investible corpus between countries (if it invests in multiple geographies) and sectors. Thereafter, the good stocks within the identified sectors are selected for investment. Thus sector allocation is a key decision.

A *bottom-up* approach on the other hand does not assign too much importance to the country-allocation and sector-allocation. If a stock is good, it is picked for investment. The approach is therefore also called *stock picking*. Stock selection is the key decision in this approach; sector allocation is a result of the stock selection decisions.

Both approaches have their merit. Top down approach minimizes the chance of being stuck with large exposure to a poor sector. Bottom up approach ensures that a good stock is picked, even if it belongs to a sector that is not so hot. What is important is that the approach selected should be implemented professionally.

Therefore, it can be said that equity returns are a function of sector and stock selection. Investors can also hope for a secular growth in a diversified mix of equity stocks when the economy does well.

8.1.2 Debt

Investment in a debt security, as in the case of a loan, entails a return in the form of interest (at a pre-specified frequency for a pre-specified period), and refund of a pre-specified amount at the end of the pre-specified period.

The pre-specified period is also called *tenor*. At the end of the tenor, the securities are said to *mature*. The process of repaying the amounts due on maturity is called *redemption*.

Debt securities that are to mature within a year are called money market securities.

The return that an investor earns or is likely to earn on a debt security is called its *yield*. The yield would be a combination of interest paid by the issuer and capital gain (if the proceeds on redemption are higher than the amount invested) or capital loss (if the proceeds on redemption are lower than the amount invested)

Debt securities may be issued by Central Government, State Governments, Banks, Financial Institutions, Public Sector Undertakings (PSU), Private Companies, Municipalities etc.

- Securities issued by the Government are called *Government Securities* or *G-Sec* or *Gilt*.
- *Treasury Bills* are short term debt instruments issued by the Reserve Bank of India on behalf of the Government of India.
- *Certificates of Deposit* are issued by Banks (for 91 days to 1 year) or Financial Institutions (for 1 to 3 years)
- *Commercial Papers* are short term securities (upto 1 year) issued by companies.
- *Bonds / Debentures* are generally issued for tenors beyond a year. Governments and public sector companies tend to issue bonds, while private sector companies issue debentures.

Since the government is unlikely to default on its obligations, Gilts are viewed as safe. The yield on Gilt is generally the lowest in the market. Since non-Government issuers can default, they tend to offer higher yields. The difference between the yield on Gilt and

the yield on a non-Government Debt security is called its *yield spread*.

The possibility of a non-government issuer defaulting on a debt security i.e. its credit risk, is measured by Credit Rating companies like CRISIL, ICRA, CARE and Fitch. They assign different symbols to indicate the credit risk in a debt security. For instance 'AAA' is CRISIL's indicator of highest safety in a debenture. Higher the credit risk, higher is likely to be the yield on the debt security.

The interest rate payable on a debt security may be specified as a fixed rate, say 6%. Alternatively, it may be a floating rate i.e. a rate linked to some other rate that may be prevailing in the market, say the rate that is applicable to Gilt. Interest rates on floating rate securities (also called *floaters*) are specified as a "Base + Spread". For example, 5-year G-Sec + 2%. This means that the interest rate that is payable on the debt security would be 2% above whatever is the rate prevailing in the market for Government Securities of 5-year maturity.

The returns in a debt portfolio are largely driven by interest rates and yield spreads.

Interest Rates

Suppose an investor has invested in a debt security that yields a return of 8%. Subsequently, yields in the market for similar securities rise to 9%. It stands to reason that the security, which was bought at 8% yield, is no longer such an attractive investment.

It will therefore lose value. Conversely, if the yields in the market go down, the debt security will gain value. Thus, there is an inverse relationship between yields and value of such debt securities which offer a fixed rate of interest.

A security of longer maturity would fluctuate a lot more, as compared to short tenor securities. Debt analysts work with a related concept called *modified duration* to assess how much a debt security is likely to fluctuate in response to changes in interest rates.

In a floater, when yields in the market go up, the issuer pays higher interest; lower interest is paid, when yields in the market go down. Since the interest rate itself keeps adjusting in line with the market, these floating rate debt securities tend to hold their value, despite changes in yield in the debt market.

If the portfolio manager expects interest rates to rise, then the portfolio is switched towards a higher proportion of floating rate instruments; or fixed rate instruments of shorter tenor. On the other hand, if the expectation is that interest rates would fall, then the manager increases the exposure to longer term fixed rate debt securities.

The calls that a fund manager takes on likely interest rate scenario are therefore a key determinant of the returns in a debt fund – unlike equity, where the calls on sectors and stocks are important.

Yield Spreads

Suppose an investor has invested in the debt security of a company. Subsequently, its credit rating improves. The market will now be prepared to accept a lower yield spread. Correspondingly, the value of the debt security will increase in the market.

A debt portfolio manager explores opportunities to earn gains by anticipating changes in credit quality, and changes in yield spreads between different market benchmarks in the market place.

8.1.3 Gold

Gold is a truly international asset, whose quality can be objectively measured. The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.

Therefore, returns in gold as an asset class depends on:

Global price of gold

Gold is seen as a safe haven asset class. Therefore, whenever there is political or economic turmoil, gold prices shoot up.

Most countries hold a part of their foreign currency reserves in gold. Similarly, institutions like the International Monetary Fund have large reserves of gold. When they come to the market to

sell, gold prices weaken. Purchases of gold by large countries tend to push up the price of gold.

Strength of the Rupee

Economic research into inflation and foreign currency flows helps analysts anticipate the likely trend of foreign currency rates.

When the rupee becomes stronger, the same foreign currency can be bought for fewer rupees. Therefore, the same gold price (denominated in foreign currency), translates into a lower rupee value for the gold portfolio. This pushes down the returns in the gold fund. A weaker rupee, on the other hand, pushes up the rupee value of the gold portfolio, and consequently the returns in gold would be higher.

8.1.4 Real Estate

Unlike gold, real estate is a local asset. It cannot be transported – and its value is driven by local factors. Some of these factors are:

Economic scenario

In the recent past, when there was uncertainty about the economy, people preferred to postpone real estate purchases. Consequently, real estate prices weakened. As the economy improves, real estate prices also tend to keep pace.

Infrastructure development

Whenever infrastructure in an area improves, real estate values go up.

Interest Rates

When money is cheap and easily available, more people buy real estate. This pushes up real estate values. Rise in interest rates therefore softens the real estate market.

The behaviour of real estate is also a function of the nature of real estate viz. residential or commercial; industrial, infrastructural, warehouse, hotel or retail.

Similarly, a lot of innovation is possible in structuring the real estate exposure. Real estate analysts are experts in assessing the future direction of different kinds of real estate, and structuring exposure to them.

The portfolio is the most important driver of returns in a scheme. The factors that drive the return of some of the asset classes were discussed here. The factors that cause fluctuation in the returns of these asset classes, and the schemes that invest in them, are discussed in a later section on risk drivers.

8.2 Measures of Returns

8.2.1 Simple Return

Whatever the nature of a mutual fund scheme, its value is reflected in the NAV.

Suppose you invested in a scheme, when its NAV was Rs 12. Later, you found that the NAV has grown to Rs 15. How much is your return?

The *Simple Return* can be calculated with the following formula:

$$\frac{(\text{Later Value} \textit{ minus } \text{Initial Value}) \times 100}{\text{Initial Value}}$$

$$\frac{(\text{Rs15} \textit{ minus } \text{Rs12}) \times 100}{\text{Rs12}}$$

i.e. 25%

8.2.2 Annualised Return

Two investment options have indicated their returns since inception as 5% and 3% respectively. If the first investment was in existence for 6 months, and the second for 4 months, then the two returns are obviously not comparable. Annualisation helps us compare the returns of two different time periods.

The *annualized return* can be calculated as:

$$\frac{\text{Simple Return} \times 12}{\text{Period of Simple Return (in months)}}$$

| Investment 1 | Investment 2 |
|---------------------------|---------------------------|
| $\frac{5\% \times 12}{6}$ | $\frac{3\% \times 12}{4}$ |
| i.e. 10% | i.e. 9% |

8.2.3 Compounded Return

If the two investment options mentioned above were in existence for 6 years and 4 years respectively, then it is possible to calculate the annualised return using the above formula. However, the effect of *compounding* is missed.

What is compounding? Suppose you place Rs 10,000 in a cumulative bank deposit for 3 years at 10% interest, compounded annually.

The bank would calculate the interest in each of the 3 years as follows:

| Year | Opening Balance (Rs) | Interest (10% on opening) | Closing Balance (Rs) |
|------|-------------------------|------------------------------|-------------------------|
| 1 | 10,000 | 1,000 | 11,000 |
| 2 | 11,000 | 1,100 | 12,100 |
| 3 | 12,100 | 1,210 | 13,310 |

Thus, at the end of the 3 year period, your principal of Rs 10,000 would have grown to Rs 13,310. If, on the other hand, the bank had calculated interest on simple basis, it would have calculated interest at Rs 1,000 for each of the 3 years, and given you Rs 13,000.

The difference between Rs 13,310 and Rs 13,000 is the effect of compounding. Longer the period of investment holding, higher would be the error, if compounding is not considered.

Compounded return can be calculated using a formula:

$$\frac{LV}{IV}^{1/n} - 1$$

Where, 'LV' is the Later Value; 'IV' is the Initial Value; and 'n' is the period in years.

Thus, if Rs 1,000 grew to Rs 4,000 in 2 years, LV = Rs 4,000; IV = Rs 1,000; n = 2 years, then the compounded return is given by the formula:

$$\frac{\text{Rs}4,000}{\text{Rs}1,000}^{1/2} - 1$$

Students who are not familiar with such exponential functions can arrive at the answer using MS Excel, by putting down the following formula in a cell:

$$=((4000/1000)^(1/2))-1$$

MS Excel will calculate the answer to be 1. This is equivalent to 1 X 100 i.e. 100%. Thus, the investment yielded a 100% compounded return during the 2 years.

Logically, for a return of 100%, the initial value of Rs 1,000 should have grown by 100% i.e. doubled to Rs 2,000 in the first year; and further doubled to Rs 4,000 in the second year. Thus LV had to reach a value of Rs 4,000, which indeed was the case.

8.2.4 Compounded Annual Growth Rate (CAGR)

It is possible to do the above calculations, by using the concerned NAVs of a scheme. Thus, if you were calculating the returns from a scheme over a specific period of time, then:

- NAV at the beginning of the period is 'IV';
- NAV at the end of the period is 'LV'; and
- Exact number of days during the period, divided by 365 is 'n'

Conceptually, these calculations give you only the return in the form of change in NAV. Another form of return for an investor in a mutual fund scheme is dividend. As seen in Unit 6, NAV goes down after a dividend is paid. Therefore, in the above examples, if a dividend were paid, then that has not been captured in any of the three kinds of returns calculated viz. Simple, Annualised and Compounded.

The above three formulae are thus applicable only for growth schemes, or for dividend schemes that have not paid a dividend during the period for which return is being calculated.

Whenever a dividend is paid – and compounding is to be considered - the CAGR technique prescribed by SEBI is used. This calculation is based on an assumption that the dividend would be re-invested in the same scheme at the ex-dividend NAV. The following example will clarify the calculation.

You invested Rs 10,000 in a scheme at Rs 10 per unit on June 30, 2008

On January 1, 2009, the scheme paid out a dividend of Rs 1 per unit. The ex-dividend NAV was Rs 12.50.

On January 1, 2010, the scheme paid out another dividend of Rs 1 per unit. The ex-dividend NAV was Rs 15.00.

Let us calculate the CAGR, which we know captures the impact of both dividend payments and compounding.

We know that 'IV', the initial value of investment is Rs 10,000

If Rs 10,000 was invested at Rs 10 per unit, then you would have 1,000 units.

The first dividend of Rs 1 per unit on 1,000 units would amount to Rs 1,000. If this amount were re-invested in the same scheme at the ex-dividend NAV, then you would have $\text{Rs } 1,000 \div \text{Rs } 12.50$ i.e. 80 additional units.

Thus, your unit-holding would have gone up from 1,000 to 1,080 units.

The second dividend of Rs 1 per unit, on the revised unit-holding of 1,080 units would amount to Rs 1,080. If this amount were re-invested in the same scheme at the ex-dividend NAV, then you would have $\text{Rs } 1,080 \div \text{Rs } 15.00$ i.e. 72 additional units.

Thus, your unit-holding would have gone up from 1,080 to 1,152 units. At Rs 15 per unit, this would be valued at Rs 17,280.

'LV', the later value of units is thus Rs 17,280.

The impact of dividend has been captured in the form of increase in the number of units.

You now need the time period in years, to compute the compounded returns. The period of June 30, 2008 to January 1, 2010 has 550 days. Dividing by 365, it translates to 1.51 years.

Now the compound interest formula can be applied.

$$\frac{LV}{IV}^{1/n} - 1$$

Where, 'LV' is the Later Value; 'IV' is the Initial Value; and 'n' is the period in years.

Here, Rs 10,000 grew to Rs 17,280 in 1.51 years, LV = Rs 17,280; IV = Rs 10,000; n = 1.51 years. CAGR is calculated by the formula:

$$\frac{Rs17,280}{Rs10,000}^{1/1.51} - 1$$

The answer can be calculated using MS Excel, by putting down the following formula in a cell:

$$= ((17280/10000)^(1/1.51))-1$$

MS Excel will calculate the answer to be 0.4365. This is equivalent to 0.4365 X 100 i.e. 43.65%. Thus, the investment

yielded a 43.65% CAGR between June 30, 2008 and January 1, 2010.

8.2.5 SEBI Norms regarding Representation of Returns by Mutual Funds in India

The following guidelines of SEBI help protect investors through transparency and fairness in disclosing returns:

Mutual funds are not permitted to promise any returns, unless it is an assured returns scheme. Assured returns schemes call for a guarantor who is named in the offer document. The guarantor will need to write out a cheque, if the scheme is otherwise not able to pay the assured return.

8.2.6 Scheme Returns and Investor Returns

The SEBI Advertising Code regarding Performance Advertisements was discussed in Unit 5.

Scheme Returns & Investor Returns

The discussion so far focused on scheme returns. Investors might have a return profile that is different, on account of the role of loads.

In the earlier example, the CAGR was calculated with the closing NAV as Rs 15. However, if an exit load of 1% was applicable, then you will receive only 99% of Rs 15 i.e. Rs 14.85 on re-purchase. Thus, your return as investor would be lower than the scheme returns.

Similarly, if the original investment had suffered an entry load of 2%, you would have bought the units at 102% of Rs 10 i.e. Rs 10.20. This would have brought down the returns. (Fortunately for the investor, entry load is no longer permitted).

Loads thus drag the investor's return below the scheme return.

Unit 6 discussed the role of taxes. This again can pull down the investor's post-tax returns.

While calculating investor returns for a period, the same formulae can be used, with the following changes:

- Instead of 'IV', the initial value of NAV (which is used for calculating scheme returns), the amount actually paid by the investor (i.e. NAV plus Entry Load, if any) would need to be used
- Instead of 'LV', the later value of NAV (which is used for calculating scheme returns), the amount actually received / receivable by the investor (i.e. NAV minus Exit Load, if any) would need to be used.

Investor returns might vary from the scheme returns also on account of choices regarding investment schedule and dividend.

8.3 Drivers of Risk in a Scheme

8.3.1 Risk in Mutual Fund Schemes

Portfolio Risk

Investors invest in a mutual fund scheme, which in turn invests in the market – debt, equity, gold or real estate in varying mixes, depending on the nature of the scheme. There is no certainty regarding the performance of the market/s, where a fund invests. Valuation in the market may go up or go down. Accordingly, the value of the portfolio and the NAV of the scheme fluctuate. Since mutual fund returns are subject to such fluctuation, the KIM of any scheme would mention the following:

“Mutual Fund Units involve investment risks including the possible loss of principal. Please read the SID carefully for details on risk factors before investment. Scheme specific Risk Factors are summarized below:” Risk factors specific to the scheme are then explained below this paragraph, in the KIM.

Further, one of the standard risk factors mentioned in any SID is “Past performance of the Sponsor / AMC / Mutual Fund does not guarantee future performance of the scheme”

Despite the risk, investment in mutual fund schemes is not a gamble. As was seen earlier, investments can be managed professionally. Various investments have different levels of risk. Astute fund managers understand the inherent risks. Thus, they can design portfolios that seek to moderate or enhance the risk as per the investment philosophy of each scheme.

Further, quantitative tools are available for portfolio optimization. Blind faith in such tools can be dangerous, because most of these tools rely on past behaviour of the markets.

As investment thought leader, Nasim Nicholas Taleb reasons in "The Black Swan", just because all the swans you have seen are white, it does not mean that black swans do not exist. Similarly, the market can behave in a manner not seen in the past. Such abnormal behaviour may be rare – like seeing a black swan – but when they happen, they can cause a lot of damage. The events in the financial market globally in 2008 and 2009 confirm Taleb's prescience on the matter.

Investment astuteness, backed by quantitative indicators, goes a long way in balancing the risk, and managing the downside arising out of those risks.

Portfolio Liquidity

When investments are liquid, there is a transparent market benchmark to its value. Further, these investments can be sold to book profits or to generate liquidity for the scheme.

SEBI has therefore laid down criteria to identify illiquid investments, and also set a ceiling to the proportion of such illiquid investments in the net assets of a scheme. The prescribed ceiling is lower for open-ended scheme, which have a greater need for liquidity because investors can offer their units for re-purchase at any time.

In 2008 and 2009, when the global markets went into turmoil, liquidity disappeared from the market. RBI had to step in to help some mutual funds fulfil their obligations.

In order to provide for eventualities, most open-end schemes in their Offer Document, reserve the right to limit or stop re-purchases in extreme cases of financial market illiquidity or volatility.

Liquid assets in the scheme

Schemes maintain a certain proportion of their assets in liquid form. This could be for either of two reasons

- They believe that the market is over-heated, and therefore prefer to sell their investments and hold the proceeds in liquid form, until the next buying opportunity comes up.
- They want to provide for contingencies such as impending dividend payment or re-purchase expectations.

Since liquid assets generally yield a lower return, they can be a drag on the scheme returns, if the other assets in the market perform better. However they protect the scheme from any distress sale of investments.

Liabilities in the scheme

As was seen in Unit 6, NAV is calculated as Net Assets divided by number of units. Any scheme's net asset is the difference

between its total assets, and its outside liabilities i.e. liabilities other than to Unit holders.

The investment portfolio represents the major chunk of total assets in any scheme's portfolio. The portfolio, as we saw, is subject to market risk.

The outside liabilities need to be paid by a scheme, irrespective of the performance of the assets. It is bad enough when the assets perform poorly, but if heavy outside liabilities need to be paid during that time, the scheme faces extreme pressure. Therefore, outside liabilities add to the risk in a mutual fund scheme.

Some outside liabilities are part of the business. For example, when a scheme purchases an investment, it is liable to pay for it. Until the payment is made as per the stock exchange settlement cycle, it will be a liability of the scheme. The practice of taking liabilities beyond what is inherent to the normal business of a mutual fund scheme is called *leveraging*. Internationally, such leveraged funds are commonly found.

Recognising the risks involved in such leveraging, SEBI regulations stipulate that:

- A mutual fund scheme cannot borrow more than 20% of its net assets
- The borrowing cannot be for more than 6 months.

- The borrowing is permitted only to meet the cash flow needs of investor servicing viz. dividend payments or re-purchase payments.

The limitations on leveraging ensure that risks arising out of balance sheet structure in Indian mutual fund schemes is considerably minimised.

Use of Derivatives

Derivatives are instruments whose value is derived from the value of one or more underlying exposures. The underlying could be a shares, exchange rate, interest rate, commodity, precious metal, index, weather, etc. The commonly known derivatives are forwards, futures, options and swaps.

As an illustration, a gold futures contract is discussed in Unit 10. A discussion on these products is otherwise beyond the scope of this Workbook. But it is important to understand that these products may be used for either of the following purposes:

Hedging against risk: Some derivative contracts are structured such that, when the market goes down the derivative contract will earn money for the investor. Thus, the derivative contract can make up for a decline in the value of the investment portfolio of a mutual fund scheme. This is a useful risk management approach.

Re-balancing the portfolio: A mutual fund scheme that wants to vary the weightage of a sector, say, pharma, in its portfolio, can do so through derivatives, without having to sell some non-pharma companies' shares, and buying some pharma companies' shares.

This can be an economical way of managing the investment exposures.

Leveraging is taking large positions with a small outlay of funds. This point is explained in the context of Gold Futures in Unit 10, where, based on an initial investment of Rs 15,000, exposure is taken to gold worth Rs 300,000 i.e. 20 times the value of the initial investment.

If a mutual fund decides to use its corpus of, say, Rs 1,000 crore, to take exposures of 20 times that amount viz. Rs 20,000 crore, then a huge risk is being taken. Even if the investments were to decline in value by 5%, the loss would be Rs 20,000 crore X 5% i.e. Rs 1,000 crore, effectively wiping out the capital of the scheme.

Mutual funds are permitted to use derivatives for hedging against risk or re-balancing the portfolio, but not for leveraging.

Investment in derivatives would have to be specifically permitted in the Offer Document. If not already provided for in the offer document, approval of investors would need to be taken, before the scheme can invest in derivatives.

Mutual Funds are barred from writing options (they can buy options) or purchasing instruments with embedded written options.

Unit-holder Churn

If an investor in an open-ended scheme offers his units for re-purchase, then the scheme needs to pay the investor. When such re-purchases go beyond the level of liquid assets, and inflows

through sale of new units, the scheme is forced to sell investments in its portfolio to generate the liquidity.

There have been occasions where institutional investors have suddenly offered a large number of units for re-purchase during difficult market conditions. The liquidity pressures force the scheme to sell assets below their intrinsic value. Consequently, retail investors suffer for no fault of theirs.

Mutual fund investors need to be cautious about schemes where the unit-holding is not widely distributed. As a measure to protect the investor, SEBI has stipulated the 20:25 rule viz. every scheme should have at least 20 investors; no investor should represent more than 25% of net assets of a scheme.

The above are key drivers of risk in all mutual fund schemes. Besides, each category of schemes has inherent risks, which flow from the uniqueness of the markets they invest in.

8.3.2 Risk in Equity Funds

Generic

Equity markets seek to reflect the value in the real economy. In performing this role, the following significant risks come up:

- The real economy goes through cycles. For a few years until 2008, the economy was booming. Then things started changing. 2009 was gloomy. However, during 2010 an economic recovery is being seen.

- In the long run, equity markets are a good barometer of the real economy – but in the short run, markets can get over-optimistic or over-pessimistic, leading to spells of greed and fear.

Equity markets therefore tend to be volatile.

Portfolio Specific

The nature of the portfolio influences scheme risk as follows:

Sector funds suffer from concentration risk - the entire exposure is to a single sector. If that sector does poorly, then the scheme returns are seriously affected.

Diversified equity funds, on the other hand, have exposure to multiple sectors. Thus, even if a few sectors perform poorly, other better performing sectors can make up. Diversified equity funds are therefore less risky than sector funds.

Thematic funds are a variation of sector funds. Here the investment is as per a theme, say, infrastructure. Multiple sectors, such as power, transportation, cement, steel, contracting and real estate are connected to infrastructure. Thus, a thematic fund tends to have wider exposure than a sector fund, but a narrower exposure than a diversified fund. Therefore, thematic funds are less risky than sector funds, but riskier than diversified equity funds.

Mid cap funds invest in mid cap stocks, which are less liquid and less researched in the market, than the frontline stocks. Therefore, the liquidity risk is high in such portfolios. Further, since

they are intrinsically not as strong as the frontline stocks, they become riskier during periods of economic turmoil.

Contra funds take positions that are contrary to the market. Such an investment style has a high risk of misjudgements.

Dividend yield funds invest in shares whose prices fluctuate less, but offer attractive returns in the form of dividend. Such funds offer equity exposure with lower downside.

Arbitrage funds are categorized as equity funds because they invest in equity. In reality, the risks are arbitrated (i.e. cancelled out), normally between the cash market and the F&O market. Therefore, the risk in this category of funds turns out to be the lowest among equity funds – even lower than diversified equity funds. The returns too are lower – more in line with money market returns, rather than equity market returns.

However, one should not forget the *basis risk* in an arbitrage fund – the risk that both cash and F&O position on a company cannot be reversed at the same time. During the time gap between unwinding of the two positions, the market can move adverse to the scheme.

8.3.3 Risk in Debt Funds

Generic

Unlike equity, debt securities are repayable on maturity. Thus, whatever the imperfections in the market, a solvent issuer will still

repay the amount promised, on maturity. This assured value on maturity makes debt a lot safer than equity.

Despite the assured value on maturity, debt securities fluctuate in value, with changes in yield in the overall market. The interest rates in the economy are influenced by factors beyond the control of any single entity. Policies of the government and RBI are unpredictable, and these too influence interest rates. A fund manager taking a wrong call on the direction of interest rates can seriously affect the scheme performance.

The debt market, especially the non-government segment, is not as vibrant and liquid as the equity market. Therefore, there is the possibility of not finding a buyer for the securities held. Similarly, when securities are not traded in the market, an element of subjectivity creeps into their valuation, and therefore the NAV.

In the past, when the markets turned illiquid, RBI has stepped in to make it easier for mutual funds to operate. Further, SEBI has laid down detailed portfolio valuation guidelines to enhance the transparency of NAV.

Portfolio Specific

Short maturity securities suffer lesser fluctuation in value, as compared to the ones with longer tenor. Therefore, liquid schemes, which invest in securities of upto 91 days maturity, have the lowest risk amongst all kinds of schemes.

Even gilt schemes, which invest in only government securities, have higher risk than liquid schemes because their NAV can

fluctuate a lot more, on account of changes in yield in the market. Greater the proportion of longer maturity securities in the portfolio, higher would be the fluctuation in NAV.

Since Fixed Maturity Plans align the maturity of their portfolio to the maturity of the scheme, the yield is relatively more predictable. However, such predictability is only on maturity, when the investee company will repay the principal to the scheme. In the interim, the value of these securities will fluctuate in line with the market – and therefore, the scheme's NAV too will fluctuate. If the FMP is structured on the basis of investment in non-government paper, then the credit risk is an issue.

When the real estate sector was in financial trouble recently, several mutual fund debt schemes faced the pressure, because they had large exposures to the sector. Portfolio concentration, in a company or a sector, enhances the risk profile of a scheme. This can be a bigger concern in Liquid Schemes, Monthly Income Plans and Fixed Maturity Plans, where the investors do not anticipate the risk.

While an equity share is an equity share, several variants of debt securities are possible. Advanced computing technology makes it possible to 'slice and dice' debt securities and create complex structures in innovative ways. In pursuit of innovation, instruments are created and traded, without the intellectual rigour that has improved our understanding of traditional debt instruments.

In the case of specific structures like securitized debt, it is not possible for the investor to study the debtors whose obligations

support the securitization. Greater reliance therefore needs to be placed on the credit rating agencies, who rate the securitized debt portfolio.

During the last two years, it was seen that global regulators and rating agencies had not fully understood the risk profile of some of the instruments they had approved or rated.

A pure capital guaranteed scheme is one where the guarantee comes out of sovereign debt i.e. government securities, which mature to the requisite value on or before the closure of the scheme. Schemes where the capital guarantee is based on investment in non-sovereign debt, even if it is a AAA-rated portfolio, have a credit risk. Therefore, the capital guarantee cannot be taken for granted. There are therefore in the nature of capital protection oriented schemes rather than capital guaranteed schemes.

A particularly risky category of debt funds is junk bond schemes. Also called high yield bond schemes, they invest in securities of poor credit quality. SEBI Regulations however limit the exposure that mutual fund schemes can take to unrated debt securities, and debt securities that are below investment grade. Therefore, this risky category of mutual fund scheme is not offered by Indian mutual funds.

8.3.4 Risk in Balanced Funds

Balanced funds invest in a mix of debt and equity. It is rare for both debt and equity markets to fare poorly at the same time.

Since the performance of the scheme is linked to the performance of these two distinct asset classes, the risk in the scheme is reduced.

Monthly Income Plan, as seen in Unit 1, is a balanced fund that seeks to combine a large debt portfolio with an yield-kicker in the form of an equity component. In such a structure, it is possible that losses in the equity component eat into the profits in the debt component of the portfolio. If the scheme has no profits to distribute, then no dividend will be declared. Thus, the investor may not get the monthly income implicit in the name Monthly Income Plan.

Some balanced schemes offer significant asset allocation flexibility to the fund manager. They can switch a large part of their portfolio between debt and equity, depending on their view on the respective markets. This kind of scheme is called *flexible asset allocation scheme*. These are risky for investors, because there is always the risk that the fund manager takes a wrong asset allocation call.

Further, investors do not know whether they are investing in a debt scheme or an equity scheme. Therefore, investors do not have clarity on whether to treat it as equity or debt, in the asset allocation for their financial plan.

8.3.5 Risk in Gold Funds

As an international commodity, gold prices are a lot more difficult to manipulate. Therefore, there is better pricing transparency.

Further, gold does well when the other financial markets are in turmoil. Similarly, when a country goes into war, and its currency weakens, gold funds give excellent returns.

These twin benefits make gold a very attractive risk proposition. An investor in a gold fund needs to be sure what kind of gold fund it is – Gold Sector Fund or ETF Gold.

8.3.6 Risk in Real Estate Funds

- Every real estate asset is different. Valuation of real estate assets is therefore highly subjective.
- Real estate transactions suffer the curse of black money. Transparency is therefore an issue.
- Real estate is a less liquid asset class. The intermediation chain of real estate agents is largely unorganized.
- Transaction costs, in the form of stamp duty, registration fees etc are high.
- Regulatory risk is high in real estate, as is the risk of litigation and other encumbrances.
- The transparency level is low even among the real estate development and construction companies. Many are family-owned and family-driven. Poor corporate governance standards increase the risks in investing in their securities.

Thus, real estate funds are quite high in risk, relative to other scheme types. Yet, they are less risk than direct investment in real estate.

8.4 Measures of Risk

Fluctuation in returns is used as a measure of risk. Therefore, to measure risk, generally the periodic returns (daily / weekly / fortnightly / monthly) are first worked out, and then their fluctuation is measured. The fluctuation in returns can be assessed in relation to itself, or in relation to some other index. Accordingly, the following risk measures are commonly used.

8.4.1 Variance

Suppose there were two schemes, with monthly returns as follows:

Scheme 1: 5%, 4%, 5%, 6%. Average=5%

Scheme 2: 5%, -10%, +20%, 5% Average=5%

Although both schemes have the same average returns, the periodic (monthly) returns fluctuate a lot more for Scheme 2. Variance measures the fluctuation in periodic returns of a scheme, as compared to its own average return. This can be easily calculated in MS Excel using the following function:

=var(range of cells where the periodic returns are calculated)

Variance as a measure of risk is relevant for both debt and equity schemes.

8.4.2 Standard Deviation

Like Variance, Standard Deviation too measures the fluctuation in periodic returns of a scheme in relation to its own average return. Mathematically, standard deviation is equal to the square root of variance.

This can be easily calculated in MS Excel using the following function:

=stdev(range of cells where the periodic returns are calculated)

Standard deviation as a measure of risk is relevant for both debt and equity schemes.

8.4.3 Beta

Beta is based on the *Capital Assets Pricing Model*, which states that there are two kinds of risk in investing in equities – *systematic risk* and *non-systematic risk*.

Systematic risk is integral to investing in the market; it cannot be avoided. For example, risks arising out of inflation, interest rates, political risks etc.

Non-systematic risk is unique to a company; the non-systematic risk in an equity portfolio can be minimized by diversification across companies. For example, risk arising out of change in management, product obsolescence etc.

Since non-systematic risk can be diversified away, investors need to be compensated only for systematic risk. This is measured by its *Beta*.

Beta measures the fluctuation in periodic returns in a scheme, as compared to fluctuation in periodic returns of a diversified stock index over the same period.

The diversified stock index, by definition, has a Beta of 1. Companies or schemes, whose beta is more than 1, are seen as more risky than the market. Beta less than 1 is indicative of a company or scheme that is less risky than the market.

Beta as a measure of risk is relevant only for equity schemes.

8.4.4 Modified Duration

As seen earlier, this measures the sensitivity of value of a debt security to changes in interest rates. Higher the modified duration, higher the interest sensitive risk in a debt portfolio.

8.4.5 Weighted Average Maturity

While modified duration captures interest sensitivity of a security better, it can be reasoned that longer the maturity of a debt security, higher would be its interest rate sensitivity. Extending the logic, weighted average maturity of debt securities in a scheme's portfolio is indicative of the interest rate sensitivity of a scheme.

Being simpler to comprehend, weighted average maturity is widely used, especially in discussions with lay investors. However, a

professional debt fund manager would rely on modified duration as a better measure of interest rate sensitivity.

8.5 Benchmarks and Performance

8.5.1 Benchmarks

Mutual fund schemes invest in the market for the benefit of Unit-holders. How well did a scheme perform this job? An approach to assess the performance is to pre-define a comparable – a benchmark – against which the scheme can be compared.

A credible benchmark should meet the following requirements:

- It should be in synch with the investment objective of the scheme i.e. the securities or variables that go into the calculation of the benchmark should be representative of the kind of portfolio implicit in the scheme's investment objective. This aspect is discussed in the next section.
- The benchmark should be calculated by an independent agency in a transparent manner, and published regularly. Most benchmarks are constructed by stock exchanges, credit rating agencies, securities research houses or financial publications.

Choice of benchmark is simplest for an index fund. The investment objective is clear on the index that the scheme would mirror. That index would then be the benchmark for the scheme. Gaps between the scheme performance, and that of the

benchmark, are called *tracking errors*. An index fund manager would seek to minimize the tracking error.

For other schemes, choice of benchmark is subjective. The benchmark for a scheme is decided by the AMC in consultation with the trustees. Offer document of the scheme has to mention the benchmark. Further, along with the past performance of the scheme, the performance of the benchmark during the same period is to be mentioned.

At a later date, the fund may choose to change the benchmark. This could be for various reasons. For instance, the investment objective of the scheme may change, or the construction of the index may change, or a better index may become available in the market. AMCs can change the benchmark in consultation with the trustees. Further, the change needs to be justified and documented.

Some mutual fund research houses compare mutual fund schemes with a benchmark which is the average returns by all schemes in the category or the best performer in the category. For example, the performance of a diversified equity fund is benchmarked against the average returns of all diversified equity funds in the market, or the best performer in the category.

8.5.2 Benchmarks for equity schemes

The following aspects of the investment objective drive the choice of benchmark in equity schemes:

Scheme Type

A sector fund would invest in only the concerned sector; while diversified funds invest in all sectors. Therefore, diversified funds need to have a diversified index, like BSE Sensex or S&P CNX Nifty or BSE 200 or BSE 500 or CNX 100 or S&P CNX 500 as a benchmark; sectoral funds select sectoral indices like BSE Bankex, BSE FMCG Index, CNX Infrastructure Index and CNX Energy Index.

Choice of Investment Universe

Some diversified equity funds invest in large companies; then there are others that focus on mid-cap stocks. The definition of mid cap keeps varying depending on valuations in the market. Further, different agencies have different criteria for classifying a stock as mid cap. Indicatively, companies with market capitalization between Rs 1,500 crore to Rs 10,000 crore can be taken as mid cap stocks.

BSE Sensex and S&P CNX Nifty are calculated based on 30 (in the case of Sensex) / 50 (in the case of Nifty) large companies. Thus, these indices are appropriate benchmarks for diversified equity funds that invest in large companies. A diversified equity fund that has chosen mid-cap stocks as its investment universe,

would find mid cap indices like CNX Midcap or Nifty Midcap 50 or BSE Midcap to be better benchmarks.

Choice of Portfolio Concentration

Some diversified equity funds prefer to have fewer stocks in their portfolio. For such schemes, appropriate benchmarks are narrow indices like BSE Sensex and NSE Nifty, which are calculated based on fewer stocks. Schemes that propose to invest in more number of companies will prefer broader indices like BSE 100 (based on 100 stocks), BSE 200 (based on 200 stocks) and S&P CNX 500 (based on 500 stocks).

Underlying Exposure

Arbitrage funds invest in equities, but their underlying exposure is not to the equity market. The reason for this seemingly contradictory statement is that arbitrage funds take opposite positions in the cash and F&O markets. Apart from various technical factors, funding cost drives the spread between the two markets. Therefore, the benchmark for an arbitrage fund is generally a short term money market index, although these are categorized as equity schemes.

8.5.3 Benchmarks for debt schemes

As per SEBI guidelines, the benchmark for debt (and balanced schemes) should be developed by research and rating agencies recommended by AMFI. CRISIL, ICICI Securities and NSE have developed various such indices.

NSE's MIBOR (Mumbai Inter-Bank Offered Rate) is based on short term money market. NSE similarly has indices for the Government Securities Market. These are available for different variations such as Composite, 1-3 years, 3-8 years, 8+ years, Treasury Bills index etc.

ICICI Securities' Sovereign Bond Index (I-Bex) is again calculated based on government securities. It consists of an umbrella index covering the entire market, and sub-indices catering to three contiguous maturity buckets. The three sub-indices are:

- Si-Bex (1 to 3 years),
- Mi-Bex (3 to 7 years) and
- Li-Bex (more than 7 years)

CRISIL gives out the values of CRISIL Gilt Bond Index and the AAA Corporate Bond Index. Some of its other debt indices are:

- CRISIL CompBEX - Composite Bond Index
- CRISIL LiquiFEX - Liquid Fund Index
- CRISIL STBEX - Short-Term Bond Index
- CRISIL Debt Hybrid Index – 60:40
- CRISIL Debt Hybrid Index – 75:25

The following aspects of the investment objective drive the choice of benchmark in debt schemes:

Scheme Type

Liquid schemes invest in securities of less than 91 days maturity. Therefore, a short term money market benchmark like NSE's MIBOR or CRISIL LiquiFEX is suitable.

Non-liquid schemes can use one of the other indices mentioned above, depending on the nature of their portfolio.

Choice of Investment Universe

Gilt funds invest only in Government securities. Therefore, indices based on Government Securities are appropriate. Debt funds that invest in a wide range of Government and non-Government securities need to choose benchmarks that are calculated based on a diverse mix of debt securities. In the absence of a vibrant market for non-Government securities, related indices are not so widely available. CRISIL's AAA corporate bond index is one such non-government securities based index.

8.5.4 Benchmarks for other schemes

Balanced Funds

These invest in a mix of debt and equity. Therefore a blend of an equity and debt index can be considered. For instance, a balanced scheme with asset allocation of about 65% in equity and balance in debt, can use a synthetic index that is calculated as

65% of BSE Sensex and 35% of I-Bex. CRISIL has also created some blended indices. CRISIL MIPEX is suitable for Monthly Income Plans; CRISIL BalanCEX can be considered by balanced funds.

Gold ETF

Gold price would be the benchmark for such funds.

Real Estate Funds

A few real estate services companies have developed real estate indices. These have shorter histories, and are yet to earn the wider acceptance that the equity indices enjoy.

International Funds

The benchmark would depend on where the scheme proposes to invest. Thus, a scheme seeking to invest in China might have the Chinese index, Hang Seng as a benchmark. S&P 500 may be appropriate for a scheme that would invest largely in the US market. A scheme that seeks to invest across a number of countries, can structure a synthetic index, that would be a blend of the indices relevant to the countries where it proposes to invest.

8.6 Quantitative Measures of Fund Manager Performance

8.6.1 Absolute & Relative Returns

In the section on calculation of returns, the focus was on absolute returns i.e. returns earned by the scheme. Having understood the concept of benchmarks, one can also do relative comparison viz. how did a scheme perform vis-à-vis its benchmark or peer group. Such comparisons are called *relative return* comparisons.

If a comparison of relative returns indicates that a scheme earned a higher return than the benchmark, then that would be indicative of *outperformance* by the fund manager. In the reverse case, the initial premise would be that the fund manager *under-performed*. Such premises of outperformance or under-performance need to be validated through deeper performance reviews.

AMCs and trustees are expected to conduct such periodic reviews of relative returns, as per SEBI Guidelines.

8.6.2 Risk-adjusted Returns

Relative returns comparison is one approach to evaluating the performance of the fund manager of a scheme. A weakness of this approach is that it does not differentiate between two schemes that have assumed different levels of risk in pursuit of the same investment objective. Therefore, although the two schemes share the benchmark, their risk levels are different. Evaluating performance, purely based on relative returns, may be unfair towards the fund manager who has taken lower risk but generated the same return as a peer.

An alternative approach to evaluating the performance of the fund manager is through the risk reward relationship. The underlying principle is that return ought to be commensurate with the risk taken. A fund manager, who has taken higher risk, ought to earn a better return to justify the risk taken. A fund manager who has earned a lower return may be able to justify it through the lower risk taken. Such evaluations are conducted through *Risk-adjusted Returns*.

There are various measures of risk-adjusted returns. This workbook focuses on three, which are more commonly used in the market.

Sharpe Ratio

An investor can invest with the government, and earn a risk-free rate of return (R_f). T-Bill index is a good measure of this risk-free return.

Through investment in a scheme, a risk is taken, and a return earned (R_s).

The difference between the two returns i.e. $R_s - R_f$ is called *risk premium*. It is like a premium that the investor has earned for the risk taken, as compared to government's risk-free return.

This risk premium is to be compared with the risk taken. Sharpe Ratio uses Standard Deviation as a measure of risk. It is calculated as

$$(R_s \text{ minus } R_f) \div \text{Standard Deviation}$$

Thus, if risk free return is 5%, and a scheme with standard deviation of 0.5 earned a return of 7%, its Sharpe Ratio would be $(7\% - 5\%) \div 0.5$ i.e. 4%.

Sharpe Ratio is effectively the risk premium per unit of risk. Higher the Sharpe Ratio, better the scheme is considered to be. Care should be taken to do Sharpe Ratio comparisons between comparable schemes. For example, Sharpe Ratio of an equity scheme is not to be compared with the Sharpe Ratio of a debt scheme.

Treynor Ratio

Like Sharpe Ratio, Treynor Ratio too is a risk premium per unit of risk.

Computation of risk premium is the same as was done for the Sharpe Ratio. However, for risk, Treynor Ratio uses Beta.

Treynor Ratio is thus calculated as:

$$(R_f \text{ minus } R_s) \div \text{Beta}$$

Thus, if risk free return is 5%, and a scheme with Beta of 1.2 earned a return of 8%, its Treynor Ratio would be $(8\% - 5\%) \div 1.2$ i.e. 2.5%.

Higher the Treynor Ratio, better the scheme is considered to be. Since the concept of Beta is more relevant for diversified equity schemes, Treynor Ratio comparisons should ideally be restricted to such schemes.

Alpha

The Beta of the market, by definition is 1. An index scheme mirrors the index. Therefore, the index scheme too would have a Beta of 1, and it ought to earn the same return as the market. The difference between an index fund's return and the market return, as seen earlier, is the *tracking error*.

Non-index schemes too would have a level of return which is in line with its higher or lower beta as compared to the market. Let us call this the *optimal return*.

The difference between a scheme's actual return and its optimal return is its *Alpha* – a measure of the fund manager's performance. Positive alpha is indicative of out-performance by the fund manager; negative alpha might indicate under-performance.

Since the concept of Beta is more relevant for diversified equity schemes, Alpha should ideally be evaluated only for such schemes.

These quantitative measures are based on historical performance, which may or may not be replicated.

Such quantitative measures are useful pointers. However, blind belief in these measures, without an understanding of the underlying factors, is dangerous. While the calculations are arithmetic – they can be done by a novice; scheme evaluation is an art - the job of an expert.

Multiple Choice Questions

1. Fundamental analysis is a evaluation of the strength of the company's price-volume charts.
 - a. True
 - b. False

2. In a top-down approach, sector allocation precedes stock selection
 - a. True
 - b. False

3. Which of the following is a truly international asset class
 - a. Real Estate
 - b. Equity
 - c. Debt
 - d. Gold

4. Loads and taxes may account for the difference between scheme returns and investor returns.
 - a. True
 - b. False

5. The most appropriate measure of returns for a scheme in existence for several years is:
- a. Simple Return
 - b. Dividend Return
 - c. Annualised Return
 - d. CAGR
6. Risk can be measured by
- a. Variance
 - b. Standard Deviation
 - c. Beta
 - d. Any of the above

Answers

1 – b, 2 – a, 3 – d, 4 – a, 5 – d, 6 – d

Checklist of Learning Points

- ☑ The portfolio is the main driver of returns in a mutual fund scheme. The underlying factors are different for each asset class.
- ☑ Fundamental Analysis and Technical Analysis are two disciplines of securities analysis. Fundamental Analysis entails review of the company's fundamentals viz. financial statements, quality of management, competitive position in its product / service market etc. Technical analysts study price-volume charts of the company's share prices.
- ☑ It is generally agreed that longer term investment decisions are best taken through a fundamental analysis approach, while technical analysis comes in handy for shorter term speculative decisions, including intra-day trading. Even where a fundamental analysis-based decision has been taken on a stock, technical analysis might help decide when to implement the decision i.e. the timing.
- ☑ Growth investment style entails investing in high growth stocks. Value investment style is an approach of picking up stocks which are valued lower, based on fundamental analysis.
- ☑ In a top-down approach, sector allocation is the key decision. Stock selection is important in bottom-up approach.
- ☑ The returns in a debt portfolio are largely driven by interest rates and yield spreads.
- ☑ If the portfolio manager expects interest rates to rise, then the portfolio is switched towards a higher proportion of floating rate instruments; or fixed rate instruments of shorter tenor. On the other hand, if the expectation is that interest rates would fall, then the manager increases the exposure to longer term fixed rate debt securities.
- ☑ This additional return offered by a non-government issuer, above the yield that the government offers, is called yield spread. Better the credit quality, lower the yield spread.

- ☑ Gold is a truly international asset, whose quality can be objectively measured. The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.
- ☑ Unlike gold, which is a global asset, real estate is a local asset. It cannot be transported – and its value is driven by local factors.
- ☑ Returns can be measured in various ways – Simple Returns, Annualised Returns, Compounded Returns, Compounded Annual Growth Rate. CAGR assumes that all dividend payouts are re-invested in the scheme at the ex-dividend NAV.
- ☑ SEBI guidelines govern disclosures of return by mutual fund schemes.
- ☑ Loads and taxes pull the investor's returns below that earned by the Scheme. Investor returns are also influenced by various actions of the investor himself.
- ☑ Risks in mutual fund schemes would depend on the nature of portfolio, its liquidity, outside liabilities and composition of unit-holders.
- ☑ Fluctuation in returns is a measure of risk. Variance and Standard Deviation are risk measures for all kinds of schemes; beta is relevant for equity; modified duration and weighted average maturity are applicable for debt schemes.
- ☑ Benchmarking is a form of relative returns comparison. It helps in assessing under-performance or out-performance.
- ☑ Choice of benchmark depends on scheme type, choice of investment universe, choice of portfolio concentration and the underlying exposure.
- ☑ Sharpe Ratio, Treynor Ratio and Alpha are bases to evaluate a fund manager's performance based on risk-adjusted returns.
- ☑ Quantitative measures are based on historical performance, which may or may not be replicated in future. Scheme evaluation is an art, not a science.

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Learning Points

You are reading this Workbook because you would like to choose between the hundreds of schemes available in the market. This unit will help you do this. It also informs you about the sources where you can easily access data related to mutual fund schemes.

It is considered a good practice to first understand the risk exposure that is appropriate for an investor (through a risk profiler, which is discussed in Unit 12). Based on that, decide how the investor's investments should be distributed between different asset classes (asset allocation, which is discussed in Unit 12).

Mutual funds are a vehicle that helps an investor take exposure to asset classes, such as equity, debt, gold and real estate. The benefits of mutual funds and various kinds of schemes were discussed in Unit 1. How does an investor select between the various schemes? Broadly, this flows from the asset allocation. Equity funds will help in equity exposure; gold funds will help in gold exposure etc.

As a structured approach, the sequence of decision making is as follows:

Step 1 – Deciding on the scheme category


Step 2 – Selecting a scheme within the category

Step 3 – Selecting the right option within the scheme

9.1 How to choose between Scheme Categories?

The risk and return drivers for various categories of schemes was discussed in the previous unit. Risk levels, especially across categories, are subjective.

Yet, as a learning-aid, a pictorial representation of the risk hierarchy of different schemes follows:

| Risk Level | Debt Funds | Hybrid Funds | Equity Funds |
|--|-----------------------|---|--|
|  High | | | Sector Funds |
| | | Balanced Funds based on Flexible Asset Allocation | |
| | | | Growth Funds |
| | High Yield Debt Funds | | Diversified Equity Funds |
| | | | Index Funds |
| | | | Value Funds |
| | | | Equity Income Funds / Dividend Yield Funds |
| | | Balanced Funds based on Fixed Asset Allocation | |
| | | Monthly Income Plans | |
| | | Capital Protection Oriented Funds | |
| | | Diversified Debt Funds | |
| | | Gilt Funds | |
| | | Money Market Funds / Liquid Schemes | |
| | Low | | |

While deciding between schemes to invest in, a few principles to keep in mind:

9.1.1 Equity Funds

While investing in equity funds, a principle to internalize is that markets are more predictable in the long term, than in the short term. So, it is better to consider equity funds, when the investment horizon is adequately long.

How long is long? Investing in equities with a horizon below 2 years can be dangerous. Ideally, the investor should look at 3 years. With an investment horizon of 5 years and above, the probability of losing money in equities is negligible. Chances are that within this 5 year horizon, the investor will have at least one window of opportunity, to sell the equity investments for an attractive return.

The role of various broad equity scheme categories in an investor's portfolio is as follows:

Active or Passive

As seen in Unit 1, index funds are passive funds. They are expected to offer a return in line with the market. An investor in an active fund is bearing a higher cost for the fund management, and a higher risk. Therefore, the returns ought to be higher i.e. the scheme should beat the benchmark, to make the investor believe that choice of active scheme was right. This, in no way, means that the higher return that **ought to** happen, **will** happen. Hence, the risk in such investments.

Investors who are more interested in the more modest objective of having an equity growth component in their portfolio, rather than the more aggressive objective of beating the equity market benchmark, would be better off investing in an index fund. This again does not mean that the NAV of an index fund will not decline in value. If the benchmark index goes down, then the NAV of the index fund too will go down. However, as suggested earlier, if the investor has a long enough horizon, then his investment will do well, in line with the overall market.

Several pension funds are limited by their charter, to take equity exposures only through index funds.

Open-ended or Close-ended

The significant benefit that open-ended funds offer is liquidity viz. the option of getting back the current value of the unit-holding from the scheme.

A close-ended scheme offers liquidity through a listing in a stock exchange. Unfortunately, mutual fund units are not that actively traded in the market. A holder of units in a close-ended scheme will need a counter-party in the stock exchange in order to be able to sell his units and recover its value.

The price of units of a closed-end scheme in the stock exchange tends to be lower than the NAV. There is no limit to this discount. Only towards the maturity of the scheme, the market price converges towards the NAV.

In the case of an open-ended scheme, the unit will be bought back by the scheme at the NAV less Exit Load. SEBI legislations prescribe a maximum exit load of 7%; in practice, it was rarely above 5%, which too was applicable only if investors exited from the scheme within a year of investment. Whatever the exit load percentage, it is known when the investor makes his investment in the scheme.

In order to provide this liquidity facility to investors, open-ended schemes maintain a part of their portfolio in liquid assets. The liquid assets component in the portfolio of an equity fund can dilute the returns that would otherwise have been earned in the equity market.

Open-end schemes are also subject to the risk of large fluctuations in net assets, on account of heavy sales or re-purchases. This can put pressure on the fund manager in maintaining the investment portfolio.

Diversified, Sector or Thematic

The critical difference between the two is that the multi-sector exposure in a diversified fund makes it less risky. Further, in an actively managed diversified fund, the fund manager performs the role of ensuring higher exposure to the better performing sectors. An investor, investing or taking money out of a sector fund has effectively taken up the role of making the sector choices.

Diversified funds should be part of the core portfolio of every investor. Investors who are comfortable with risk can invest in

sector funds. Further, an investor should have the skill to make the right sector choices, before venturing into sector funds.

Some investors are more comfortable identifying promising investment themes (for example, infrastructure), rather than specific sectors (like cement, steel etc.). Such investors can decide on investment themes they would like to buy.

At any point of time, an investor in sector funds should have exposure to not more than 3 - 5 different sectors. Investing in more sectors than that, would amount to having a diversified portfolio of sector funds. The investor can save a lot of time by investing in a diversified fund instead!

Large-cap v/s Mid-cap / Small Cap Funds

When industry scenario is difficult, the resource strengths of large-cap front-line stocks help them survive; many mid-cap / small cap companies fall by the way side during economic turmoil, because they lack the resources to survive. It can therefore be risky to invest in mid-cap / small cap funds during periods of economic turmoil.

As the economy recovers, and investors start investing in the market, the valuations in front-line stocks turn expensive. At this stage, the mid-cap / small cap funds offer attractive investment opportunities.

Over a long period of time, some of the mid-cap and small-cap companies will become large companies, whose stocks get re-rated in the market. The healthy returns on such stocks can boost the returns on mid-cap and small-cap portfolios.

Growth or Value funds

As seen in the previous unit, in the initial phases of a bull run, growth funds tend to offer good returns. Over a period of time, as the growth stocks get fully valued, value funds tend to perform better. Investments in value funds yield benefits over longer holding periods.

In a market correction, the Growth funds can decline much more than value funds.

Fund Size

The size of funds needs to be seen in the context of the proposed investment universe. Thus, a sector fund with net assets of Rs 1,000 crore, is likely to find investment challenging if the all the companies in the sector together are worth only about Rs 10,000 crore. On the other hand, too small a fund size means that the scheme will not benefit from economies of scale.

Portfolio Turnover

Purchase and sale of securities entails broking costs for the scheme. Frequent churning of the portfolio would not only add to the broking costs, but also be indicative of unsteady investment management.

Portfolio Turnover Ratio is calculated as Value of Purchase and Sale of Securities during a period divided by the average size of net assets of the scheme during the period. Thus, if the sale and purchase transactions amounted to Rs 10,000 crore, and the

average size of net assets is Rs 5,000 crore, then the portfolio turnover ratio is $\text{Rs } 10,000 \text{ cr} \div \text{Rs } 5,000 \text{ cr}$ i.e. 200%. This means that investments are held in the portfolio, on an average for 12 months $\div 2$ i.e. 6 months.

The portfolio turnover needs to be viewed in the light of the investment style. 6 month holding period may be too short for a value investment style, but perfectly acceptable for a scheme that wants to benefit from shifts in momentum in pivotal.

Arbitrage funds

These are not meant for equity risk exposure, but to lock into a better risk-return relationship than liquid funds – and ride on the tax benefits that equity schemes offer.

Domestic Equity v/s International Equity funds

When an Indian investor invests in equities abroad, he is essentially taking two exposures:

- An exposure on the international equity market
- An exposure to the exchange rate of the rupee. If the investor invests in the US, and the US Dollar becomes stronger during the period of his investment, he benefits; if the US Dollar weakens (i.e. Rupee becomes stronger), he loses.

Investors might consider investing abroad, for any of the following reasons:

- He feels that the overall returns (international equity + exchange rate movement) will be attractive
- He is taking an asset allocation call of diversifying his investments to reduce the risk.

9.1.2 Debt Funds

Debt funds are less risky than equity funds for the reasons discussed in the previous unit.

These can be structured in various ways to meet useful investor needs. Some of these structures, and their benefits to investors were discussed in Unit 1. The risks in these structures, as discussed in the previous unit, need to be understood.

Regular Debt Funds v/s MIPs

MIP has an element of equity in its portfolio. Investors who do not wish to take any equity exposure, should opt for a regular debt fund.

Open-end Funds v/s FMP

FMP is ideal when the investor's investment horizon is in synch with the maturity of the scheme, and the investor is looking for a predictable return that is superior to what is available in a fixed deposit. The portfolio risk discussed in the previous unit needs to be considered too.

An investor who is likely to require the funds anytime, would be better off investing in a normal open-ended debt fund.

Gilt Funds v/s Diversified Debt Funds

Diversified debt funds invest in a mix of government securities (which are safer) and non-government securities (which offer higher yields, but are subject to credit risk). A diversified mutual fund scheme that manages its credit risk well can generate superior returns, as compared to a Gilt Fund.

Long-Term Debt Fund v/s Short Term Debt Fund

As discussed in the previous unit, longer term debt securities fluctuate more than shorter term debt securities. Therefore, NAVs of long-term debt funds tend to be more volatile than those of short-term debt funds.

It was also seen that as yields in the market goes down, debt securities gain in value. Therefore, long term debt funds would be sensible in declining interest rate scenarios. However, if it is expected that interest rates in the market would go up, it would be safer to go with Short Term Debt Funds.

Money Market Funds / Liquid Schemes

An investor seeking the lowest risk ought to go for a liquid scheme. However, the returns in such instruments are lower. The comparable for a liquid scheme in the case of retail investors is a savings bank account. Switching some of the savings bank deposits into liquid schemes can improve the returns for him. Businesses, which in any case do not earn a return on their current account, can transfer some of the surpluses to liquid schemes.

Just as it is not advisable to keep all of one's moneys in a savings bank account – some money needs to go into fixed deposits in order to improve returns – similarly, all of one's mutual fund investments should not be in liquid schemes. Hence there is a need to invest in other debt schemes – and also equity schemes. Schemes that are named 'liquid plus' are not more liquid. These are like the Short Term Funds discussed earlier. They try to earn a higher return by investing in securities of a longer tenor than the regular liquid schemes. As the tenor increases, risk too increases. In order to prevent potential mis-selling, SEBI has now disallowed the use of the term 'liquid plus' as a fund type.

Regular Debt Funds v/s Floaters

Regular debt funds are subject to the risk of fluctuations in NAV. Since floating rate debt securities tend to hold their values, even if interest rates fluctuate, the NAV of floaters tend to be steady. When the interest rate scenario is unclear, then floaters are a safer option. Similarly, in rising interest rate environments, floaters can be considered as an alternative to short term debt funds and liquid funds.

9.1.3 Balanced Schemes

The discussion on asset allocation brought out the benefit of diversifying the investment portfolio across asset classes. An investor desirous of having a mix of debt and equity exposures has two options –

- He can invest in a mix of equity schemes and debt schemes

- He can invest in a balanced scheme, which in turn invests in a mix of equity and debt securities.

The first option obviously implies more decisions on scheme selection that the investor would need to take. But the benefit is that the investor has a wide array of scheme options, within both equity and debt scheme categories. Further, the investor would be in a position to work towards a mix of debt and equity that is most appropriate for him.

Investing in a balanced scheme makes things simpler for the investor, because fewer scheme selection decisions need to be taken. However, the investor would need to go by the debt-equity mix in the investment portfolio of the schemes.

Investors need to be cautious of the high risk potential of a variant of balanced schemes that are structured as flexible asset allocation schemes.

Further, balanced schemes may be taxed as a debt scheme or an equity scheme depending on the scheme's investment portfolio. The two categories of schemes have completely different tax implications, as was discussed in Unit 6.

9.1.4 Gold Funds

Investors need to differentiate between Gold ETF and Gold Sector Funds. The latter are schemes that invest in shares of gold mining and other gold processing companies. The performance of these gold sector funds is linked to the profitability and gold reserves of these gold companies – unlike Gold ETFs whose performance

would track the price of gold. When gold metal prices go up, gold mining companies with large reserves of gold can appreciate a lot more than the gold metal. Conversely, they can also fall more when gold metal prices decline.

Investors therefore need to understand the structure of the gold schemes more closely, before investing.

9.1.5 Other Funds

As per mutual fund regulations, debt, equity, gold and real estate are the only asset classes permitted for investment. More categories might come up in future. Or some foreign schemes with other asset class exposures might be permitted. The discussion in the previous unit on risks in gold and real estate funds are a useful primer on the kinds of issues to explore in any new category of mutual fund schemes.

9.2 How to select a Scheme within a Scheme Category?

All the 35+ AMCs that are permitted to do business in India, meet the minimum eligibility criteria set by law. Different AMCs have different approaches, styles and value systems in doing business. An investor has to be comfortable with the AMC, before investing in any of its schemes.

An investor buying into a scheme is essentially buying into its portfolio. Most AMCs share the portfolio of all their schemes in their website on a monthly basis.

Equity investors would like to convince themselves that the sectors and companies where the scheme has taken higher exposure, are sectors / companies that are indeed promising.

Long-term watchers of mutual fund performance also develop views on AMCs/ Fund Managers that are more prescient in identifying changes in market trends.

Experienced researchers can also identify how true the fund manager is, to the promised investment style. A large proportion of fully-valued front-line stocks in the portfolio of a value fund is indicative of the fund manager not being true to the promised investment style. Debt investors would ensure that the weighted average maturity of the portfolio is in line with their view on interest rates viz. Higher weighted average maturity during periods of declining interest rates; lower weighted average maturity, and higher exposure to floating rate instruments during periods of rising interest rates.

Investors in non-gilt debt schemes will keep an eye on credit quality of the portfolio – and watch out for sector concentration in the portfolio, even if the securities have a high credit rating.

Some other parameters that are considered while selecting schemes within a category, are as follows:

Fund Age

A fund with a long history has a track record that can be studied. A new fund managed by a portfolio manager with a lackluster track-record is definitely avoidable.

Fund age is especially important for equity schemes, where there are more investment options, and divergence in performance of schemes within the same category tends to be more.

Scheme running expenses

Any cost is a drag on investor's returns. Investors need to be particularly careful about the cost structure of debt schemes, because in the normal course, debt returns can be much lower than equity schemes. Similarly, since index funds follow a passive investment strategy, a high cost structure is questionable in such schemes.

Tracking Error

Amongst index schemes, tracking error is a basis to select the better scheme. Lower the tracking error, the better it is. Similarly, Gold ETFs need to be selected based on how well they track gold prices.

Regular Income Yield in Portfolio

Schemes' income comes out of regular income (dividend income in equity portfolio, interest income in debt portfolio) and capital gains. Regular incomes are seen as a more stable source of income than capital gains. Therefore, a high regular income yield is a strong positive for a scheme.

Risk, return and risk-adjusted returns as parameters to evaluate schemes were discussed in the previous unit. These form the basis for mutual fund research agencies to assign a rank to the performance of each scheme within a scheme category (ranking).

Some of these analyses cluster the schemes within a category into groups, based on well-defined performance traits (rating).

Every agency has its distinctive methodology for ranking / rating, which are detailed in their websites. Investors should understand the broad parameters, before taking decisions based on the ranking / rating of any agency.

Some research agencies follow a star system for the rating. Thus, a 5-star scheme is better than a 4-star scheme; 4-star scheme is better than 3-star, and so on and so forth.

Quarterly performance ranking of schemes over a period of time shows that the best ranking fund in a quarter is not necessarily the best ranking fund in the next quarter. Therefore, seeking to be invested in the best fund in every category in every quarter is neither an ideal objective, nor a feasible target proposition. Indeed, the costs associated with switching between schemes are likely to severely impact the investors' returns.

The investor should therefore aim to stay invested in schemes that are in the top "few" in their category on a consistent basis. The "few" could mean 3 to 5, in categories that have few schemes; or the top 10-15%, in categories where there are more schemes. Investors need to bear in mind that these rankings and categories are based on historical performance, which may or may not be repeated in future.

The investor also needs to remember that beyond performance of the scheme, loads make a difference to the investor's return.

9.3 Which is the Better Option within a Scheme?

The underlying returns in a scheme, arising out of its portfolio and cost economics, is what is available for investors in its various options viz. Dividend payout, dividend re-investment and growth options.

Dividend payout option has the benefit of money flow to the investor; growth option has the benefit of letting the money grow in the fund on gross basis (i.e. without annual taxation). Dividend re-investment option neither gives the cash flows nor allows the money to grow in the fund on gross basis.

Re-purchase transactions are treated as a sale of units by the investor. Therefore, there can be an element of capital gain (or capital loss), if the re-purchase price is higher (or lower) than the cost of acquiring those units. Some investors may like to book such a capital gain (or capital loss) to set it off against some other capital loss (or capital gain), where such set off is permitted. The broad set off rules, including the differential treatment of long term and short term, were discussed in Unit 6.

Re-purchase transactions in equity schemes are subject to STT. Further, there is no dividend distribution tax on equity schemes. Therefore, subject to the set-off benefit that some investors might seek, it is better to receive moneys in an equity scheme in the form of dividend, rather than re-purchase of units.

The dividend payout option seems attractive for investors wanting a regular income. It should however be kept in mind that even in a

Monthly Income Plan, dividend declaration is a function of distributable surplus. If there is no surplus to distribute, dividend cannot be declared. Therefore, the need for regular income is better met through a SWP for the requisite amount. {Sale of units under an SWP may have STT implication (equity schemes) and capital gains tax implication (equity and debt schemes)}.

Dividend flows in a debt scheme come with the associated dividend distribution tax, which reduces the NAV. Thus, the investor is effectively bearing the cost of the dividend distribution tax, although it might be paid by the scheme to the income tax authorities. This cost might be fine for an investor in the high tax bracket, because the impact of the distribution tax would be lower than his marginal rate of taxation (which comes into play for taxation, if the investment is held for less than a year). But for a pensioner with no taxable income, or whose marginal rate of taxation is lower, it is meaningless to bear the cost of distribution tax. As seen earlier, SWP can take care of any need for a regular income – and there is no dividend distribution tax on the repurchase proceeds. The capital gains tax impact however, would need to be checked.

Thus, taxation and liquidity needs are a factor in deciding between the options. The advisor needs to understand the investor's situation before advising.

9.4 Sources of Data to track Mutual Fund Performance

It would now be evident to the reader, that mutual fund performance reviews are data intensive. An investor seeking to do the research by collecting daily NAV and dividend declaration information from the newspapers can find it frustratingly time consuming.

Fortunately, ready-made solutions are available in the market. Many AMCs, distribution houses and mutual fund research houses offer free tools in their website. Using these, the performance of schemes, their ranking, rating etc. and comparison of performance between specific schemes, is easy to ascertain.

Investors, who wish to access the raw data of NAVs, dividends etc. in a systematic manner – and distributors who wish to integrate such information into their investor-management systems and processes – can subscribe to the data from these vendors. Based on the subscription, data updates can be easily downloaded every day through the internet.

The mix of free and paid content is subject to change. The following are some of the agencies that are active in this field:

- Credence Analytics (www.credenceanalytics.com)
- CRISIL (www.crisil.com)
- Lipper (www.lipperweb.com)

- Morning Star (www.morningstar.com)
- Value Research (www.valueresearchonline.com)

The listing of websites is only a piece of information for the reader. Users need to convince themselves before subscribing to, or using any of this information. Neither SEBI nor NISM nor the author certifies the data or information or tools that these agencies offer.

Multiple Choice Questions

1. Equity markets are more predictable in the long term than the short.
 - a. True
 - b. False
2. Arbitrage funds are meant to give better equity risk exposure
 - a. True
 - b. False
3. The comparable for a liquid scheme is
 - a. Equity scheme
 - b. Balanced Scheme
 - c. Gilt Fund
 - d. Savings Bank account
4. Which of the following aspects of portfolio would an investor in a debt scheme give most importance
 - a. Sector selection
 - b. Stock selection

- c. Weighted Average Maturity
 - d. Number of securities in portfolio
5. Mutual fund ranking and rating amount to the same.
- a. True
 - b. False

Answers

1 – a, 2 – b, 3 – d, 4 – c, 5 – b

Checklist of Learning Points

- ☑ Asset allocation is the approach of spreading one's investments between multiple asset classes to diversify the underlying risk.
- ☑ The sequence of decision making in selecting a scheme is: Step 1 – Deciding on the scheme category (based on asset allocation); Step 2 – Selecting a scheme within the category; Step 3 – Selecting the right option within the scheme.
- ☑ While investing in equity funds, a principle to internalize is that markets are more predictable in the long term, than in the short term. So, it is better to consider equity funds, when the investment horizon is adequately long.
- ☑ In an actively managed diversified fund, the fund manager performs the role of ensuring higher exposure to the better performing sectors or stocks. An investor, investing or taking money out of a sector fund has effectively taken up the role of making the sector choices.
- ☑ It can be risky to invest in mid-cap / small cap funds during periods of economic turmoil. As the economy recovers, and investors start investing in the market, the valuations in front-line stocks turn expensive. At this stage, the mid-cap / small cap funds offer attractive investment opportunities. Over longer periods, some of the mid/small cap companies have the potential to become large-cap companies thus rewarding investors.
- ☑ Arbitrage funds are not meant for equity risk exposure, but to lock into a better risk-return relationship than liquid funds – and ride on the tax benefits that equity schemes offer.
- ☑ The comparable for a liquid scheme in the case of retail investors is a savings bank account. Switching some of the savings bank deposits into liquid schemes can improve the returns for him. Businesses, which in any case do not earn a return on their current account, can transfer some of the surpluses to liquid schemes.

- ✓ Balanced schemes offer the benefit of diversity of asset classes within the scheme. A single investment gives exposure to both debt and equity.
- ✓ Investors need to understand the structure of the gold schemes more closely, before investing.
- ✓ Equity investors would like to convince themselves that the sectors and companies where the scheme has taken higher exposure, are sectors / companies that are indeed promising.
- ✓ Debt investors would ensure that the weighted average maturity of the portfolio is in line with their view on interest rates.
- ✓ Investors in non-gilt debt schemes will keep an eye on credit quality of the portfolio – and watch out for sector concentration in the portfolio, even if the securities have a high credit rating.
- ✓ Any cost is a drag on investor's returns. Investors need to be particularly careful about the cost structure of debt schemes.
- ✓ Amongst index schemes, tracking error is a basis to select the better scheme. Lower the tracking error, the better it is. Similarly, Gold ETFs need to be selected based on how well they track gold prices.
- ✓ Mutual fund research agencies assign a rank to the performance of each scheme within a scheme category (ranking). Some of these analyses cluster the schemes within a category into groups, based on well-defined performance traits (rating).
- ✓ Seeking to be invested in the best fund in every category in every quarter is neither an ideal objective, nor a feasible target proposition. Indeed, the costs associated with switching between schemes are likely to severely impact the investors' returns.
- ✓ The underlying returns in a scheme, arising out of its portfolio and cost economics, is what is available for investors in its various options viz. Dividend payout, dividend re-investment and growth options.
- ✓ Dividend payout option has the benefit of money flow to the investor; growth option has the benefit of letting the money grow in the fund on gross basis (i.e. without annual taxation). Dividend-re-

investment option neither gives the cash flows nor allows the money to grow in the fund on gross basis. Taxation and liquidity needs are a factor in deciding between the options. The advisor needs to understand the investor's situation before advising.

- ☑ Many AMCs, distribution houses and mutual fund research houses offer free tools in their website to help understand performance of schemes.

10. Selecting the Right Investment Products for Investors

Learning Objectives

Investors tend to block their money in physical assets. This unit compares physical assets with financial assets.

Distributors and financial advisors perform an invaluable role in helping investors decide on investment products. Mutual fund schemes are just one of the various alternatives that investors consider for investment. This unit discusses some of these alternatives in the context of mutual fund schemes.

Since the focus of this Workbook is on mutual funds, the discussion on other investment products is illustrative, not exhaustive.

10.1 Financial and Physical Assets

10.1.1 The Concept

An investor who buys land, building, a painting or gold can touch and feel them. The investor can choose to build a house in the land, stay in the building, display the painting and make jewellery out of the gold. Such assets are called *physical assets*. Similarly, a company buying plant and machinery is buying physical assets. Physical assets have value and can be touched, felt and used.

An investor who buys shares in a company is entitled to the benefits of the shareholding – but this entitlement cannot be touched or felt. The paper on which the share certificate is printed can be touched and felt, but that paper is only evidence supporting the benefit that the investor is entitled to. The benefit itself is intangible. Such assets are called *financial assets*. Financial assets have value, but cannot be touched, felt or used as part of their core value.

Shares, debentures, fixed deposits, bank accounts and mutual fund schemes are all examples of financial assets that investors normally invest in. Their value is not in the paper or receipt on which they are printed, but in what they are entitled to viz. a share in the fortunes of the company (share), an amount repayable on a future date (debenture or fixed deposit), an amount that you can withdraw any time (bank account) or a share in the fortunes of a portfolio (mutual fund scheme).

10.1.2 The Implication

Comfort

The investor in a physical asset draws psychological comfort from the fact that the asset is in the investor's possession, or under the investor's control in a locker. Whatever may happen in the outside world, the investor can still use the physical asset.

The value encashment in a financial asset, on the other hand, can depend on the investee company. What if the company closes down? What if the bank or mutual fund scheme goes bust? These are issues that bother investors.

The difference in comfort is perhaps a reason why nearly half the wealth of Indians is locked in physical assets.

Mutual fund schemes can offer a lot of comfort, in this regard, as was discussed in Unit 3.

Unforeseen Events

The comfort of investors in physical assets is tempered by an understanding of consequences of unforeseen events. A physical asset is completely gone, or loses substantial value, when stolen, or if there is a fire, flood or such other hazard. It is for this reason that some owners of physical assets insure them against such hazards.

Theft or fire or flood, have no impact on the entitlement of the investor to a financial asset. The investor can always go the investee organization i.e. company or bank or mutual fund where the money is invested, and claim the entitlement, based on records of the investee company and other documentary evidence. Dematerialisation makes these processes a lot simpler.

Economic Context

Investor's money in land, or gold does not benefit the economy. On the other hand, money invested in financial assets can be productive for the economy.

The money that the government mobilizes through issue of government securities can go towards various productive purposes.

The company, whose shares are bought, can invest the money in a project, which can boost production, jobs and national income.

The bank where the bank account or fixed deposit is maintained can lend the money to such productive activities, and thus help the economy.

Similarly, mutual fund schemes that invest in securities issued by companies are effectively assisting in building the nation and the economy.

This explains the interest of the government in converting more and more of the physical assets held by investors, into financial assets. Recognising that comfort is a key factor that can boost the conversion, a lot of importance is given to the regulation of the banks and financial markets. Independent regulators like RBI and SEBI therefore focus on creating the requisite policy framework, and ensuring that participants in the market adhere to the policy.

Gold and real estate are two physical assets, where a significant portion of investor wealth is blocked. The risk and return drivers for these asset classes was discussed in Unit 8. Let us now understand them in the context of format of holding - physical or financial.

10.2 Gold – Physical or Financial?

Gold suffers one of the highest risks of loss through theft. Storage in bank lockers too costs money. The exposure to gold as a financial asset can be taken in different forms:

- Gold ETF was discussed in Units 1 and 8.
- Gold Sector Fund was discussed in Units 1 and 8.
- Gold futures contracts are traded in commodity exchanges like the National Commodities Exchange (NCDEX) and Multi-Commodity Exchange (MCX). The value of these contracts goes up or down in line with increases or decreases in gold prices.

When an investor buys a gold futures contract, the entire value of the contract does not need to be paid. Only a percentage of the contract value (margin) is to be paid immediately. Investors can therefore take positions that are a multiple of what is otherwise possible with the money at hand. This practice of taking larger positions based on margin payments is called *leveraging*.

Let us consider an example.

Suppose gold can be bought at Rs 1,500 per gram. Purchase of 10 grams would cost Rs 15,000.

If it were possible to buy a gold futures contract at Rs 15,000 for 10 grams, the exchange would ask for a margin of, say, 5%. Initial margin payable would be $\text{Rs } 15,000 \times 5\%$ i.e. Rs 750.

Thus, with an initial outlay of merely Rs 750, the investor is able to take a position worth Rs 15,000 in gold. Extending the logic further, if the investor had Rs 15,000 to invest in gold futures, he can take a position worth Rs $15,000 \div 5\%$ i.e. Rs 300,000.

(It may be noted that exchanges have their contract specifications which set the minimum contract size).

Investors need to be cautious of the risks associated with leveraging. In the above example, the investor took a position of Rs 300,000, based on investment of Rs 15,000 in gold futures. A 10% decline in gold price would translate into a loss of Rs 30,000. The investor needs to look at his ability to bear that loss – not merely consider how much exposure can be taken with the initial investment.

Further, gold futures contracts have a limited contract period. Thus, a 3-month gold futures contract will expire at the end of 3 months. An investor who wishes to continue his exposure will therefore need to roll over the position – effectively, enter into a fresh contract. Every contract purchase has its associated costs.

Gold ETF on the other hand is an open-ended scheme with no fixed maturity. It is very rare for an open-ended scheme to liquidate itself early. Therefore, an investor who buys into a gold ETF can hold the position indefinitely.

Gold deposit schemes are offered by some banks. This is like a fixed deposit in gold. An investor depositing gold into a Gold deposit scheme is given a receipt promising to pay back the same quantity of gold (or its equivalent value) on maturity. During the

period of deposit, interest is paid at regular intervals, as in the case of a regular fixed deposit, but calculated as a pre-specified percentage on the value of the gold deposited.

An investor contemplating whether to invest in gold in physical form or financial, needs to note that:

Wealth Tax is applicable on gold holding (beyond the jewellery meant for personal use). However, mutual fund schemes (gold linked or otherwise) and gold deposit schemes are exempted from Wealth Tax.

Mutual fund schemes and deposit schemes offer the facility of appointing nominees who will be entitled to the proceeds in the event of death of the depositor / investor. Gold in physical form does not offer this facility.

10.3 Real Estate – Physical or Financial?

Besides the risk of loss on account of fire and other hazards, real estate in physical form is prone to a few more disadvantages:

- The ticket size i.e. the minimum amount required for investing in real estate is high. The investment would run into lakhs of rupees, even to buy agricultural land.
- Unless the budget is very high, and the value of properties bought are very low, investors would find it difficult to maintain

a diverse portfolio of real estate. Thus, they end up with concentration risk.

- Once purchased, vacant land can be encroached upon by others. Therefore, unless properly guarded and secured, one can lose control and ownership of real estate, especially vacant land.
- Real estate is an illiquid market. Investment in financial assets as well as gold can be converted into money quickly and conveniently within a few days at a transparent price. Since real estate is not a standardized product, there is no transparent price – and deals can take a long time to execute.
- Once a deal is executed, the transaction costs, such as stamp duty and registration charges, are also high. At times, these regulatory processes are also non-transparent and cumbersome.
- When property is let out, there is a risk that the lessee may lay his own claim to the property (ownership risk) or be unable to pay the rent (credit risk).

It is for these reasons that real estate investors prefer to invest through Real estate mutual funds. The ticket sizes are flexible; further professional managers of the real estate portfolio are in a better position to manage the other risks and issues associated with real estate investment.

10.4 Fixed Deposit or Debt Scheme

Several investors are comfortable only in placing money in bank deposits; they do not invest in debt schemes, partly because of lack of awareness. The following are features where bank deposits clearly score over mutual funds:

- In the event that a bank fails, the deposit insurance scheme of the government comes to the rescue of small depositors. Upto Rs 1 lakh per depositor in a bank (across branches) will be paid by the insurer. This limit is inclusive of principal and interest. Mutual fund schemes do not offer any such insurance.
- The depositor can also prematurely close the deposit at any time. However, a penalty needs to be borne for such premature closure.
- Mutual fund debt schemes are superior to bank deposits in the following respects:
- With a bank deposit, the depositor can never earn a return higher than the interest rate promised. In a mutual fund scheme, no return is guaranteed – however it is possible to earn returns that are much higher than in a bank deposit. There have been occasions, where investors even in lower risk government securities funds, have earned in excess of 20% p.a.

Given the way debt securities are priced in the market, such abnormally high returns become possible when interest rates in the economy decline. In such a scenario, the NAV of the debt

fund would go up, thus boosting the value of the investment of the investor – this is precisely the scenario when fixed depositors in a bank worry about the lower interest rates that banks offer on their deposits.

- Interest earned in a bank deposit is taxable each year. However, if a unit holder allows the investment to grow in a mutual fund scheme (which in turn is exempt from tax), then no income tax is payable on year to year accretions. In the absence of the drag of annual taxation, the money can grow much faster in a mutual fund scheme.
- Mutual funds offer various facilities to make it easy for investors to move their money between different kinds of mutual fund schemes. These are not available with a bank deposit.

10.5 New Pension Scheme

Pension Funds Regulatory and Development Authority (PFRDA) is the regulator for the New Pension Scheme. Two kinds of pension accounts are envisaged:

- Tier I (Pension account), is non-withdrawable.
- Tier II (Savings account) is withdrawable to meet financial contingencies. An active Tier I account is a pre-requisite for opening a Tier II account.

- Investors can invest through Points of Presence (POP). They can allocate their investment between 3 kinds of portfolios:
- Asset Class E: Investment in predominantly equity market instruments
- Asset Class C: Investment in Debt securities other than Government Securities
- Asset Class G: Investments in Government Securities.

Investors can also opt for life-cycle fund. With this option, the system will decide on a mix of investments between the 3 asset classes, based on age of the investor.

The 3 asset class options are managed by 6 Pension Fund Managers (PFMs). The investors' moneys can thus be distributed between 3 portfolios X 6 PFMs = 18 alternatives.

The NPS offers fewer portfolio choices than mutual funds. However, NPS offers the convenience of a single Personal Retirement Account Number (PRAN), which is applicable across all the PFMs where the investor's money is invested. Further, the POPs offer services related to moneys invested with any of the PFMs.

10.6 Other Financial Products

The inherent risk and return characteristics vary between financial products. The discussions in this and the previous units give a good perspective on the key parameters on which various financial products need to be compared, before investment decisions are taken.

Exercise

Multiple Choice Questions

1. More than 50% of the wealth of Indians is held in physical assets
 - a. True
 - b. False
2. Gold Futures are superior to ETF Gold as a vehicle for life-long investment in gold.
 - a. True
 - b. False
3. As regards wealth tax, ETF Gold is superior to physical gold.
 - a. True
 - b. False
4. The New Pension Scheme is regulated by
 - a. SEBI
 - b. IRDA
 - c. PFRDA
 - d. AMFI

5. An investor under the new pension scheme can choose which of the following asset classes
- a. Equities
 - b. Corporate debt
 - c. Government Securities
 - d. Any of the above

Answers

1 – a, 2 – b, 3 – a, 4 – c, 5 – d

Checklist of Learning Points

- ☑ Physical assets like land, building and gold have value and can be touched, felt and used. Financial assets have value, but cannot be touched, felt or used as part of their core value. Shares, debentures, fixed deposits, bank accounts and mutual fund schemes are all examples of financial assets that investors normally invest in.
- ☑ The difference in comfort is perhaps a reason why nearly half the wealth of Indians is locked in physical assets.
- ☑ There are four financial asset alternatives to holding gold in physical form – ETF Gold, Gold Sector Fund, Gold Futures & Gold Deposits.
- ☑ Wealth Tax is applicable on gold holding (beyond the jewellery meant for personal use). However, mutual fund schemes (gold linked or otherwise) and gold deposit schemes are exempted from Wealth Tax.
- ☑ Real estate in physical form has several disadvantages. Therefore, investors worldwide prefer financial assets as a form of real estate investment.
- ☑ Bank deposits and mutual fund debt schemes have their respective merits and demerits.
- ☑ Pension Funds Regulatory and Development Authority (PFRDA) is the regulator for the New Pension Scheme. Two kinds of pension accounts are envisaged: Tier I (Pension account), is non-withdrawable. Tier II (Savings account) is withdrawable to meet financial contingencies. An active Tier I account is a pre-requisite for opening a Tier II account.
- ☑ The NPS offers fewer portfolio choices than mutual funds. However, NPS offers the convenience of a single Personal Retirement Account Number (PRAN), which is applicable across all the PFMs where the investor's money is invested. Further, the POPs offer services related to moneys invested with any of the PFMs.

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11. Helping Investors with Financial Planning

Learning Objective

Financial Planning is an approach to building long term relationships with clients. It is also a need for large sections of investors. This unit introduces the concept of financial planning.

11.1 Introduction to Financial Planning

11.1.1 What is Financial Planning?

Everyone has needs and aspirations. Most needs and aspirations call for a financial commitment. Providing for this commitment becomes a financial goal. Fulfilling the financial goal sets people on the path towards realizing their needs and aspirations. People experience happiness, when their needs and aspirations are realized within an identified time frame.

For example, a father wants his son, who has just passed his 10th standard Board examinations, to become a doctor. This is an aspiration. In order to realize this, formal education expenses, coaching class expenses, hostel expenses and various other expenses need to be incurred over a number of years. The estimated financial commitments towards these expenses become financial goals. These financial goals need to be met, so that the son can become a doctor.

Financial planning is a planned and systematic approach to provide for the financial goals that will help people realise their needs and aspirations, and be happy.

11.1.2 Assessment of Financial Goals

The financial goals related to making the son a doctor, call for commitments over a period of about 6 years – 2 years of undergraduate studies, coaching class expenses for preparing for the medical entrance exams, followed by the medical education and hostel expenses.

An estimate of these future expenses (the financial goals) requires the following inputs:

| Year | Current Cost (Rs) | Likely Inflation (% p.a.) | Likely Exchange Rate impact (% p.a.) |
|------|----------------------|---------------------------------|---|
| 1 | 100,000 | 7% | N.A. |
| 2 | 120,000 | 7% | N.A. |
| 3 | 1,000,000 | 7% | N.A. |
| 4 | 500,000 | 7% | N.A. |

| | | | |
|---|---------|----|------|
| 5 | 500,000 | 7% | N.A. |
| 6 | 500,000 | 7% | 2% |

- How much would be the expense, if it were incurred today?
- How many years down the line, the expense will be incurred?
- During this period, how much will the expense rise on account of inflation?
- If any of these expenses are to be incurred in foreign currency, then how would changes in exchange rate affect the financial commitment?

Suppose the inputs are as follows:

The costs mentioned above, in today's terms, need to be translated into the rupee requirement in future. This is done using the formula $A = P \times (1 + i)^n$, where,

A = Rupee requirement in future

P = Cost in today's terms

i = inflation

n = Number of years into the future, when the expense will be incurred.

The below-mentioned calculations can be done on calculator. However, the calculations are easier, using MS Excel formulae.

For instance, the Rs 120,000 money requirement of 2 years down the line, calculated at today's prices, translates into a future rupee requirement of " $=120,000 \times (1 + 7\%)^2$ " (as entered in MS Excel). The answer is Rs 137,388.

The same exercise done for the other year's expenses gives a year-wise future rupee requirement as follows:

| Year | MS Excel Formula | Future Rupee Requirement (Rs) |
|------|-------------------------------------|----------------------------------|
| 1 | $=100,000 \times (1 + 7\%)^1$ | 107,000 |
| 2 | $=120,000 \times (1 + 7\%)^2$ | 137,388 |
| 3 | $=1,000,000 \times (1 + 7\%)^3$ | 1,225,043 |
| 4 | $=500,000 \times (1 + 7\%)^4$ | 655,398 |
| 5 | $=500,000 \times (1 + 7\%)^5$ | 701,276 |
| 6 | $=500,000 \times (1 + 7\% + 2\%)^6$ | 838,550 |

These are the financial goals that need to be met, in order to realize the aspiration of seeing the son become a doctor.

11.1.3 Investment Horizon

The year-wise financial goals statement throws up the investment horizon. It would be risky to expect the first three years expenses to be met out of equity investments being made today. But equity is a viable investment option for expenses starting from Year 4.

In most cases, the investor would have some regular income out of which part of the expenses can be met. So the investments being considered now need to fund only the balance of the financial goals.

11.1.4 Assessing the Fund Requirement

Suppose the investor is comfortable about meeting Rs 100,000 of the expense each year. The balance would need to be provided out of investments being made today. How much is that investment requirement? This can be calculated using a variation of the formula used earlier i.e. $P = A \div (1 + r)^n$, where:

P, A and n have the same meaning as in the earlier formula.

r represents the return expected out of the investment portfolio.

Suppose requirements of Years 1 to 3 are met out of debt investments that would yield a return of 6% p.a. The requirements of Year 4 onwards are met out of equity investments that are

estimated to yield a return of 9% p.a.. The amount that would need to be invested today is as follows:

| Year | Required (Rs) | Regular Savings (Rs) | Balance Required (Rs) | MS Excel Formula | Investment Required Today (Rs) |
|--------------|---------------|----------------------|-----------------------|-------------------|--------------------------------|
| 1 | 107,000 | 100,000 | 7,000 | =7000/(1+6%)^1 | 6,604 |
| 2 | 137,388 | 100,000 | 37,388 | =37388/(1+6%)^2 | 33,275 |
| 3 | 1,225,043 | 100,000 | 1,125,043 | =1125043/(1+6%)^3 | 944,608 |
| 4 | 655,398 | 100,000 | 555,398 | =555398/(1+9%)^4 | 393,458 |
| 5 | 701,276 | 100,000 | 601,276 | =601276/(1+9%)^5 | 390,788 |
| 6 | 838,550 | 100,000 | 738,550 | =7000/(1+9%)^1 | 440,373 |
| Total | | | | | 22,09,106 |

Thus, a total amount of Rs 22,09,106 needs to be invested right now – Rs 984,487 in debt with a 3-year horizon, and Rs 12,24,619 in equity with a 4 – 6 year horizon to meet the financial goals that would help the investor realize the aspiration of seeing his son become a doctor.

Many AMCs and websites offer calculators that help with the above calculations.

11.1.5 Financial Planning Objectives and Benefits

The objective of financial planning is to ensure that the right amount of money is available at the right time to meet the various financial goals of the investor. This would help the investor realize his aspirations and experience happiness.

An objective of financial planning is also to let the investor know in advance, if some financial goal is not likely to be fulfilled. In the above case, the investor knows that if he cannot make the requisite combined investment of Rs 21,33,238 in debt and equity today, then financial constraints may affect the realization of his aspiration.

Thanks to advance information available through financial planning, timely corrective actions can be taken, such as:

- Reviewing what is a “need” and what is a “desire” that can be postponed for the more desirable objective of realizing the aspiration of son becoming a doctor.

- Moving to a smaller house, or a house in a less expensive locality, to release more capital.
- Improving the future annual savings by economizing on expense, or taking up an extra part-time job, or influencing the spouse to take up employment for some time.

The financial planner may also suggest a loan to meet the heavy expense of Year 3. Financial planning thus helps investors realize their aspirations and feel happy. It also helps the financial planner, because the process of financial planning helps in understanding the investor better, and cementing the relationship with the investor's family. This becomes the basis for a long term relationship between the investor and the financial planner.

11.1.6 Need for Financial Planners

Most investors are either not organized, or lack the ability to make the calculations described above. A financial planner's service is therefore invaluable in helping people realize their needs and aspirations.

Even if the investor knows the calculations, the knowledge of how and where to invest may be lacking. The financial planner thus steps in to help the investor select appropriate financial products and invest in them.

Transactions such as purchase of house or car, or even education, necessitate a borrowing. The financial planner can help the investor decide on the optimal source of borrowing and structure the loan arrangement with the lender.

Taxation is another area that most investors are unclear about. Financial planners who are comfortable with the tax laws can therefore help the investor with tax planning, so as to optimize the tax outflows.

Financial planners can also help investors in planning for contingencies. This could be through advice on insurance products, inheritance issues etc.

The financial planner thus is in a position to advise investors on all the financial aspects of their life.

11.2 Alternate Financial Planning Approaches

The financial plan detailed above is a “goal-oriented financial plan” – a financial plan for a specific goal related to the aspiration to make the son a doctor.

An alternate approach is a “comprehensive financial plan” where all the financial goals of a person are taken together, and the investment strategies worked out on that basis. The steps in creating a comprehensive financial plan, as proposed by the Certified Financial Planner – Board of Standards (USA) are as follows:

- Establish and Define the Client-Planner Relationship
- Gather Client Data, Define Client Goals
- Analyse and Evaluate Client's Financial Status

- Develop and Present Financial Planning Recommendations and / or Options
- Implement the Financial Planning Recommendations
- Monitor the Financial Planning Recommendations

The comprehensive financial plan captures the estimated inflows from various sources, and estimated outflows for various financial goals, including post-retirement living expenses. The plan can go several decades into the future.

A comprehensive financial plan calls for significantly more time commitment on the part of both the investor and the financial planner. However, the time commitment needs to be viewed as an investment in a long term relationship.

11.3 Life Cycle and Wealth Cycle in Financial Planning

While working on a comprehensive financial plan, it is useful to have a perspective on the Life Cycle and Wealth Cycle of the investor.

11.3.1 Life Cycle

These are the normal stages that people go through, viz.:

Childhood

During this stage, focus is on education in most cases. Children are dependents, rather than earning members. Pocket money,

cash gifts and scholarships are potential sources of income during this phase. Parents and seniors need to groom children to imbibe the virtues of savings, balance and prudence. Values imbibed during this phase set the foundation of their life in future.

Young Unmarried

The earning years start here. A few get on to high-paying salaries early in their career. Others toil their way upwards. Either way, the person needs to get into the habit of saving. The fortunate few who start off well have to avoid falling into the trap of unsustainable life styles.

Equity SIPs and Whole-life insurance plans are great ways to force the young unmarried into the habit of regular savings, rather than lavish the money away.

This is the right age to start investing in equity. Personal plans on marriage, transportation and residence determine the liquidity needs. People for whom marriage is on the anvil, and those who wish to buy a car / two-wheeler or house may prefer to invest more in relatively liquid investment avenues. Others have the luxury of not having to provide much for liquidity needs. Accordingly, the size of the equity portfolio is determined.

Young Married

A cushion of assets created during the early earning years can be a huge confidence booster while taking up the responsibilities associated with marriage.

Where both spouses have decent jobs, life can be financially comfortable. They can plan where to stay in / buy a house, based on job imperatives, life style aspirations and personal comfort. Insurance is required, but not so critical.

Where only one spouse is working, life insurance to provide for contingencies associated with the earning spouse are absolutely critical. In case the earning spouse is not so well placed, ability to pay insurance premia can be an issue, competing with other basic needs of food, clothing and shelter. Term insurance (where premium is lower) possibilities have to be seriously explored and locked into.

Depending on the medical coverage provided by the employer/s, health insurance policy cover too should be planned. Even where the employer provides medical coverage, it would be useful to start a low value health insurance policy, to provide for situations when an earning member may quit a job and take up another after a break. Further, starting a health insurance policy earlier and not having to make a claim against it for a few years, is the best antidote to the possibility of insurance companies rejecting future insurance claims / coverage on account of what they call "pre-existing illness".

While buying an insurance policy, there has to be clarity on whether it is a cashless policy i.e. a policy where the insurance company directly pays for any hospitalization expenses. In other policies, the policy-holder has to bear the expense first and then

claim re-imbusement from the insurer. This increases the liquidity provisions that need to be made for contingencies.

All family members need to know what is covered and what is not covered in the policy, any approved or black listed health services provider, and the documentation and processes that need to be followed to recover money from the insurer. Many insurance companies have outsourced the claim settlement process. In such cases, the outsourced service provider, and not the insurer, would be the touch point for processing claims.

Married with Young Children

Insurance needs – both life and health - increase with every child. The financial planner is well placed to advise on a level of insurance cover, and mix of policies that would help the family maintain their life style in the event of any contingency.

Expenses for education right from pre-school to normal schooling to higher education is growing much faster than regular inflation. Adequate investments are required to cover this.

Married with Older Children

The costs associated with helping the children settle i.e. cost of housing, marriage etc are shooting up. If investments in growth assets like shares and real estate, are started early in life, and maintained, it would help ensure that the children enjoy the same life style, when they set up their independent families.

Pre-Retirement

By this stage, the children should have started earning and contributing to the family expenses. Further, any loans taken for purchase of house or car, or education of children should have been extinguished. The family ought to plan for their retirement – what kind of lifestyle to lead, and how those regular expenses will be met.

Retirement

At this stage, the family should have adequate corpus, the interest on which should help meet regular expenses. The need to dip into capital should come up only for contingencies – not to meet regular expenses.

The availability of any pension income and its coverage (only for the pensioner or extension to family in the event of death of pensioner) will determine the corpus requirement.

Besides the corpus of debt assets to cover regular expenses, there should also be some growth assets like shares, to protect the family from inflation during the retirement years.

11.3.2 Wealth Cycle

This is an alternate approach to profile the investor. The stages in the Wealth Cycle are:

Accumulation

This is the stage when the investor gets to build his wealth. It covers the earning years of the investor i.e. the phases of the life cycle from Young Unmarried to Pre-Retirement.

Transition

Transition is a phase when financial goals are in the horizon. E.g. house to be purchased, children's higher education / marriage approaching etc. Given the impending requirement of funds, investors tend to increase the proportion of their portfolio in liquid assets viz. money in bank, liquid schemes etc.

Inter-Generational Transfer

During this phase, the investor starts thinking about orderly transfer of wealth to the next generation, in the event of death. The financial planner can help the investor understand various inheritance and tax issues, and help in preparing Will and validating various documents and structures related to assets and liabilities of the investor.

It is never too early to plan for all this. Given the consequences of stress faced by most investors, it should ideally not be postponed beyond the age of 50.

Reaping / Distribution

This is the stage when the investor needs regular money. It is the parallel of retirement phase in the Life Cycle.

Sudden Wealth

Winning lotteries, unexpected inheritance of wealth, unusually high capital gains earned – all these are occasions of sudden wealth, that need to be celebrated. However, given the human nature of frittering away such sudden wealth, the financial planner can channelize the wealth into investments, for the long term benefit of the investor's family.

In such situations, it is advisable to initially block the money by investing in a liquid scheme. An STP from the liquid schemes into equity schemes will help the long term wealth creation process, if advisable, considering the unique situation of the investor.

Given the change of context, and likely enhancement of life style expectations, a review of the comprehensive financial plan is also advisable in such situations.

Understanding of both life cycle and wealth cycle is helpful for a financial planner. However, one must keep in mind that each investor may have different needs and unique situations; the recommendations may be different for different investors even within the same life cycle or wealth cycle stages.

11.3.3 Financial Planning Tools

The financial plan preparation becomes simpler with the aid of packaged software. These help not only in estimating the cash flow requirements and preparing the financial plan, but also ongoing monitoring of the portfolio.

A few mutual funds and securities companies provide limited financial planning tools in their websites. A serious financial planner might like to invest in off-the-shelf software that will enable storing of relevant client information confidentially, and offer ongoing support to the clients.

Multiple Choice Questions

1. Today's costs can be translated into future requirement of funds using the formula:
 - a. $A = P \times (1 + i)^n$
 - b. $A = P / (1 + i)^n$
 - c. $P = A^n \times (1 + i)$
 - d. $P = A^n \times (1 + i)$

2. Providing funds for a daughter's marriage is an example of
 - a. Goal-oriented Financial Plan
 - b. Comprehensive Financial Plan
 - c. Financial goal
 - d. None of the above

3. According to the Certified Financial Planner – Board of Standards (USA), the first stage in financial planning is
 - a. Analyse and Evaluate Client's Financial Status
 - b. Establish and Define the Client-Planner Relationship
 - c. Gather Client Data, Define Client Goals

- d. Develop and Present Financial Planning Recommendations and / or Options
4. Investor can get into long term investment commitments in
- a. Distribution Phase
 - b. Transition Phase
 - c. Inter-generational Phase
 - d. Accumulation Phase
5. Distribution phase of Wealth Cycle is a parallel of Retirement phase of Life Cycle
- a. True
 - b. False

Answers

1 – a, 2 – c, 3 – b, 4 – d, 5 – a

Checklist of Learning Points

- ☑ Financial planning is a planned and systematic approach to provide for the financial goals that will help people realise their aspirations, and feel happy.
- ☑ The costs related to financial goals, in today's terms, need to be translated into the rupee requirement in future. This is done using the formula $A = P \times (1 + i)^n$
- ☑ The objective of financial planning is to ensure that the right amount of money is available at the right time to meet the various financial goals of the investor.
- ☑ An objective of financial planning is also to let the investor know in advance, if some financial goal is not likely to be fulfilled.
- ☑ The process of financial planning helps in understanding the investor better, and cementing the relationship with the investor's family. This becomes the basis for a long term relationship between the investor and the financial planner.
- ☑ A "goal-oriented financial plan" is a financial plan for a specific goal. An alternate approach is a "comprehensive financial plan" where all the financial goals of a person are taken together, and the investment strategies worked out on that basis
- ☑ The Certified Financial Planner – Board of Standards (USA) proposes the following sequence of steps for a comprehensive financial plan:
 - Establish and Define the Client-Planner Relationship
 - Gather Client Data, Define Client Goals
 - Analyse and Evaluate Client's Financial Status
 - Develop and Present Financial Planning Recommendations and / or Options
 - Implement the Financial Planning Recommendations
 - Monitor the Financial Planning Recommendations
- ☑ Life Cycle and Wealth cycle approaches help understand the investor better.

12. Recommending Model Portfolios and Financial Plans

Learning Objective

This concluding Unit discusses three key aspects of financial planning – how to understand the risk profile of investors, how to decide on an asset allocation mix for the investor, and an approach to deciding on model portfolios.

12.1 Risk Profiling

12.1.1 Need for Risk Profiling

As seen earlier, various schemes have different levels of risk. Similarly, there are differences between investors with respect to the levels of risk they are comfortable with (*risk appetite*). At times there are also differences between the level of risk the investors *think* they are comfortable with, and the level of risk they *ought to be* comfortable with.

Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments.

The investment advice is dependent on understanding both aspects of risk:

- Risk appetite of the investor
- Risk level of the investment options being considered.

12.1.2 Factors that Influence the Investor's Risk Profile

Some of the factors and their influence on risk appetite are as follows:

| Factor | Influence on Risk Appetite |
|---|--|
| <i>Family Information</i> | |
| <ul style="list-style-type: none"> • Earning Members | Risk appetite increases as the number of earning members increases |
| <ul style="list-style-type: none"> • Dependent Members | Risk appetite decreases as the number of dependent members increases |
| <ul style="list-style-type: none"> • Life expectancy | Risk appetite is higher when life expectancy is longer |
| <i>Personal Information</i> | |
| <ul style="list-style-type: none"> • Age | Lower the age, higher the |

| | |
|------------------------------|---|
| | risk that can be taken |
| • Employability | Well qualified and multi-skilled professionals can afford to take more risk |
| • Nature of Job | Those with steady jobs are better positioned to take risk |
| • Psyche | Daring and adventurous people are better positioned mentally, to accept the downsides that come with risk |
| <i>Financial Information</i> | |
| • Capital base | Higher the capital base, better the ability to financially take the downsides that come with risk |
| • Regularity of Income | People earning regular income can take more risk than those with unpredictable income streams |

More such factors can be added. The financial planner needs to judge the investor based on such factors, rather than just ask a question “How much risk are you prepared to take?”

12.1.3 Risk Profiling Tools

Some AMCs and securities research houses provide risk profiling tools in their website. Some banks and other distributors have proprietary risk profilers. These typically revolve around investors answering a few questions, based on which the risk appetite score gets generated.

Some of these risk profile surveys suffer from the investor trying to “guess” the right answer, when in fact there is no right answer. Risk profiling is a tool that can help the investor; it loses meaning if the investor is not truthful in his answers.

Some advanced risk profilers are built on the responses to different scenarios that are presented before the investor. Service providers can assess risk profile based on actual transaction record of their regular clients.

While such tools are useful pointers, it is important to understand the robustness of such tools before using them in the practical world. Some of the tools featured in websites have their limitations. The financial planner needs to use them judiciously.

12.2 Asset Allocation

12.2.1 The Role of Asset Allocation

'Don't put all your eggs in one basket' is an old proverb. It equally applies to investments.

The discussion on risk in Unit 8, highlighted how the risk and return in various asset classes (equity, debt, gold, real estate etc.) are driven by different factors. For example, during the recessionary situation in 2007-09, equity markets in many countries fared poorly, but gold prices went up. Thus, an investor who had invested in both gold and equity, earned better returns than an investor who invested in only equities. The distribution of an investor's portfolio between different asset classes is called *asset allocation*.

Economic environments and markets are dynamic. Predictions about markets can go wrong. With a prudent asset allocation, the investor does not end up in the unfortunate situation of having all the investments in an asset class that performs poorly.

Some international researches suggest that asset allocation and investment policy can better explain portfolio performance, as compared to selection of securities within an asset class (stock selection) and investment timing.

12.2.2 Asset Allocation Types

In the discussion on risk in balanced schemes in Unit 8, the concept of flexible asset allocation was introduced. It was

reasoned that these are more risky than balanced funds with more stable asset allocation policies. Balanced funds that adopt such stable asset allocation policies are said to be operating within a fixed asset allocation framework.

At an individual level, difference is made between Strategic and Tactical Asset Allocation.

Strategic Asset Allocation is the ideal that comes out of the risk profile of the individual. Risk profiling is key to deciding on the strategic asset allocation. The most simplistic risk profiling thumb rule is to have as much debt in the portfolio, as the number of years of age. As the person grows older, the debt component of the portfolio keeps increasing. This is an example of strategic asset allocation.

As part of the financial planning process, it is essential to decide on the strategic asset allocation that is advisable for the investor.

Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market. An investor who decides to go overweight on equities i.e. take higher exposure to equities, because of expectations of buoyancy in industry and share markets, is taking a tactical asset allocation call.

Tactical asset allocation is suitable only for seasoned investors operating with large investible surpluses. Even such investors might like to set a limit to the size of the portfolio on which they would take frequent tactical asset allocation calls.

12.3 Model Portfolios

Since investors' risk appetites vary, a single portfolio cannot be suggested for all. Financial planners often work with model portfolios – the asset allocation mix that is most appropriate for different risk appetite levels. The list of model portfolios, for example, might read something like this:

Young call centre / BPO employee with no dependents

50% diversified equity schemes (preferably through SIP); 20% sector funds; 10% gold ETF, 10% diversified debt fund, 10% liquid schemes.

Young married single income family with two school going kids

35% diversified equity schemes; 10% sector funds; 15% gold ETF, 30% diversified debt fund, 10% liquid schemes.

Single income family with grown up children who are yet to settle down

35% diversified equity schemes; 15% gold ETF, 15% gilt fund, 15% diversified debt fund, 20% liquid schemes.

Couple in their seventies, with no immediate family support

15% diversified equity index scheme; 10% gold ETF, 30% gilt fund, 30% diversified debt fund, 15% liquid schemes.

As the reader would appreciate, these percentages are illustrative and subjective. The critical point is that the financial planner should

have a model portfolio for every distinct client profile. This is then tweaked around based on specific investor information. Thus, a couple in their seventies, with no immediate family support **but very sound physically and mentally, and a large investible corpus** might be advised the following portfolio, as compared with the previous model portfolio.

20% diversified equity scheme; 10% diversified equity index scheme; 10% gold ETF, 25% gilt fund, 25% diversified debt fund, 10% liquid schemes.

Within each of these scheme categories, specific schemes and options can be identified, based on the approach described in Unit 10.

Multiple Choice Questions

1. Risk appetite of investors is assessed through
 - a. Risk Appetizers
 - b. Asset Allocators
 - c. Risk Profilers
 - d. Financial Plan

2. The objective of asset allocation is risk management
 - a. True
 - b. False

3. The asset allocation that is worked out for an investor based on risk profiling is called
 - a. Tactical Asset Allocation
 - b. Fixed Asset Allocation
 - c. Flexible Asset Allocation
 - d. Strategic Asset Allocation

4. Model portfolios are a waste of time for financial planners
 - a. True
 - b. False

5. How much equity would you suggest for a young well settled unmarried individual
 - a. 100%
 - b. 80%
 - c. 60%
 - d. 40%

Answers

1 - c, 2 - a, 3 - d, 4 - b, 5 - b

Checklist of Learning Points

- ☑ There are differences between investors with respect to the levels of risk they are comfortable with (risk appetite).
- ☑ Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments. Risk profilers have their limitations.
- ☑ Risk profile is influenced by personal information, family information and financial information.
- ☑ Spreading one's exposure across different asset classes (equity, debt, gold, real estate etc.) balances the risk.
- ☑ Some international researches suggest that asset allocation and investment policy can better explain portfolio performance, as compared to being exposed to the right asset classes (asset allocation) is a more critical driver of portfolio profitability than selection of securities within an asset class (stock selection) and investment timing.
- ☑ Strategic Asset Allocation is the ideal that comes out of the risk profile of the individual. Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market.
- ☑ Financial planners often work with model portfolios – the asset allocation mix that is most appropriate for different risk appetite levels. The financial planner would have a model portfolio for every distinct client profile.

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List of Abbreviations

| | |
|------|---|
| A/A | Articles of Association |
| ACE | AMFI Code of Ethics |
| AGNI | AMFI Guidelines & Norms for Intermediaries |
| AMC | Asset Management Company |
| AMFI | Association of Mutual Funds in India |
| AML | Anti-Money Laundering |
| ARN | AMFI Registration Number |
| ASBA | Application Supported by Blocked Amount |
| CAGR | Compounded Annual Growth Rate |
| CDSC | Contingent Deferred Sales Charge |
| CFT | Combating Financing of Terrorism |
| CVL | CDSL Ventures Ltd |
| DD | Demand Draft |
| DDT | Dividend Distribution Tax (Additional Tax on Income Distribution) |
| DP | Depository Participant |
| ECS | Electronic Clearing Service |
| F&O | Futures & Options |
| FCNR | Foreign Currency Non-Resident account |
| FEMA | Foreign Exchange Management Act, 1999 |
| FII | Foreign Institutional Investor |
| FIRC | Foreign Inward Remittance Certificate |
| FMP | Fixed Maturity Plan |
| HUF | Hindu Undivided Family |
| ISC | Investor Service Centre |
| KIM | Key Information Memorandum |
| KYC | Know Your Customer |

| | |
|-----------|--|
| M/A | Memorandum of Association |
| M-Banking | Mobile Banking |
| MF | Mutual Fund |
| Micro-SIP | SIP with annual aggregate investment less than Rs 50,000 |
| MIN | Mutual Fund Identification Number |
| NAV | Net Asset Value |
| NBFC | Non-Banking Finance Company |
| NEFT | National Electronic Funds Transfer |
| NFO | New Fund Offer |
| NOC | No Objection Certificate |
| NPA | Non-Performing Asset |
| NRE | Non-Resident External account |
| NRI | Non-Resident Indian |
| NRO | Non-Resident Ordinary account |
| PAN | Permanent Account Number |
| PDC | Post-Dated Cheques |
| PFM | Pension Fund Manager |
| PFRDA | Pension Fund Regulatory & Development Authority |
| PIO | Person of Indian Origin |
| PMLA | Prevention of Money Laundering Act |
| PoA | Power of Attorney / Points of Acceptance, depending on context |
| POP | Points of Presence |
| RBI | Reserve Bank of India |
| RTA | Registrars & Transfer Agents |
| RTGS | Real Time Gross Settlement |
| SAI | Statement of Additional Information |

| | |
|-------|--|
| SEBI | Securities & Exchange Board of India |
| SID | Scheme Information Document |
| SIP | Systematic Investment Plan |
| SRO | Self Regulatory Organisation |
| STP | Systematic Transfer Plan |
| STT | Securities Transaction Tax |
| SWP | Systematic Withdrawal Plan |
| SWIFT | Society for Worldwide Interbank Financial Telecommunication |

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Browsing List

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- BSE (www.bseindia.com)
- Credence Analytics (www.credenceanalytics.com)
- CRISIL (www.crisil.com)
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- Morning Star (www.morningstar.com)
- NSE (www.nseindia.com)
- RBI (www.rbi.org.in)
- SEBI (www.sebi.gov.in) - Mutual Funds Section
- Value Research (www.valueresearchonline.com)

National Institute of Securities Markets

(Established by the Securities and Exchange Board of India)

Plot 82, Sector 17, Vashi, Navi Mumbai – 400 705

www.nism.ac.in