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Do Indian Business Group-Owned Mutual Funds Maximize Value For Their Investors? A Summary

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1. Introduction

More than a third of all listed companies in India are owned by business groups. Many of these groups started as traders and money lenders several centuries back but now operate in diverse industries such as heavy manufacturing, construction, communications, and even information technology.[13] Following the financial market liberalization in the early 1990s, many of these business group (BG) families ventured into financial services as well. Several of them now offer insurance and mutual fund services, either alone or in partnership with global financial services firms. More recently, the Reserve Bank of India (RBI) along with the government has been debating whether to provide banking licenses to corporate houses as well.

While the benefits of allowing entry for well-capitalized and deeply experienced business groups into financial services is easy to see, the costs are more difficult to assess, especially given the potential for conflicts of interest. Unlike in traditional businesses where business groups own (or at least have majority interest in) and operate primarily to maximize their own interest with little regulatory constraint, BG-owned financial ventures are mostly fiduciaries who need to maximize the interests of their principals in the financial industry, namely, investors in the case of mutual funds or depositors in the case of banks. Whether they do so is a question that can only be answered using data. In this study, we try to provide an answer to this question using data from the Indian mutual fund industry.

In the mutual fund industry, business groups promote asset management companies

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[13] For example, the Aditya Birla Group operates approximately 40 companies, many of which are listed on the major exchanges and span such diverse sectors as fibers, metals, cement apparel, chemicals, fertilizers, telecom, and information technology.

that manage money on behalf of hundreds of investors. While money management *per se* is not an issue, the fact that they can invest in their own group's companies complicates matters. Business group fund managers may have access to private information about their own group firms or about the industries in which they operate. This information can be exploited to generate superior returns for their investors compared to returns from other non-business group-owned funds. In contrast, fund managers can also act opportunistically and maximize their group's interests by supporting the stock price of underperforming group firms or by providing liquidity to group firms by subscribing to their security issuances.

2. Our Study

Using monthly data related to investment choices and returns of all Indian equity mutual fund growth schemes that existed between January 2002 and October 2010, we explore whether BG funds maximize value for their investors or for their parent firms.[14] We include redeemed or closed schemes in our sample. Our final sample contains 367 fund schemes that belong to 36 fund families, of which 118 schemes belong to one of the eight business groups in our sample.

We study the portfolio choices of these fund schemes and see whether they overweighed or underweighed their investments in their own group firms, and whether their choices impact the returns (on a benchmark-adjusted and risk-adjusted basis) that they generate for their investors. We look at the magnitude of the BG funds' investment relative to an average fund to determine overinvestment or underinvestment. The Securities and Exchange Board of India's (SEBI) guidelines provide broad restrictions on investments in group entities—fund schemes cannot invest more than 25% of their assets in the listed companies of their groups at any point in time.

Further, we examine whether they deviate in their investment in "rival" firms, i.e., non-BG firms that operate in the same industry as the group firms do. While overinvestment or underinvestment in group firms can be explained through direct economic benefits for the group, investment in rival firms could be driven by strategic reasons that may provide indirect benefits for the group. BG fund managers can exploit their superior information

[14] Three schemes are offered to investors under the same portfolio: bonus, dividend, and growth. The difference between the schemes is in the method of payout—dividend and bonus schemes make periodic distributions, while growth schemes make no distributions to investors. We focus only on growth schemes to make our returns computations easier. However, we add the assets of all three schemes to determine the scheme's assets under management (AUM).

about the industry by overinvesting in rival firms, while they may underinvest in order to reduce liquidity and increase the cost of capital relative to that of the group firms.

3. Results

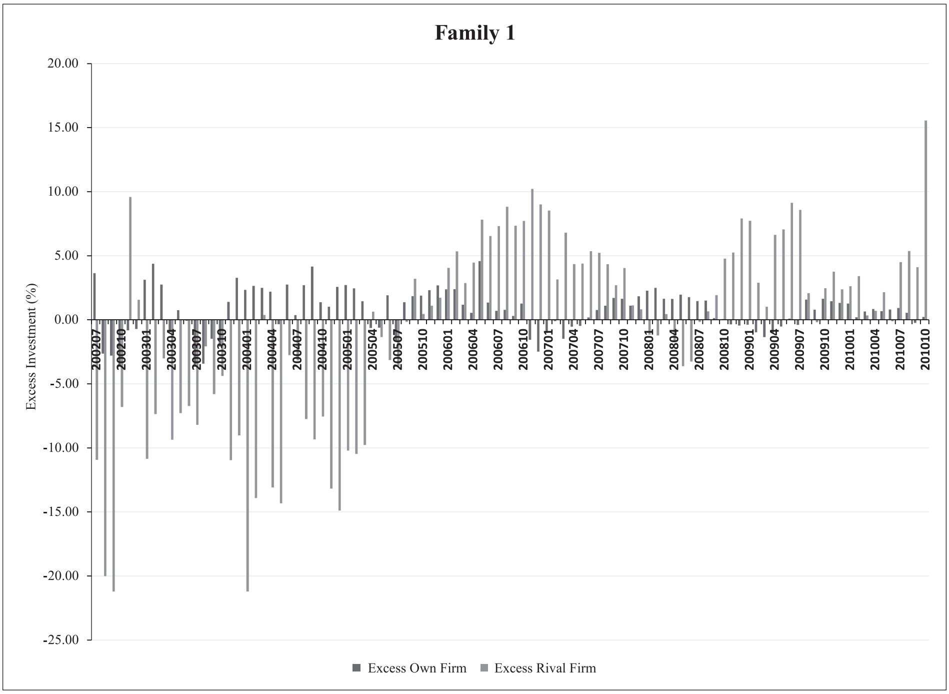
We find strong evidence that BG fund schemes vary considerably in their investment in group firms compared to an average fund scheme in the industry, although the average size of such investment (2% of AUM) is much less than the maximum prescribed by the SEBI (25% of AUM). Family 1 has around 57% of its AUM invested in either its group firms or their rivals, while Families 7 and 8 have only around 12% of AUM invested in this manner.

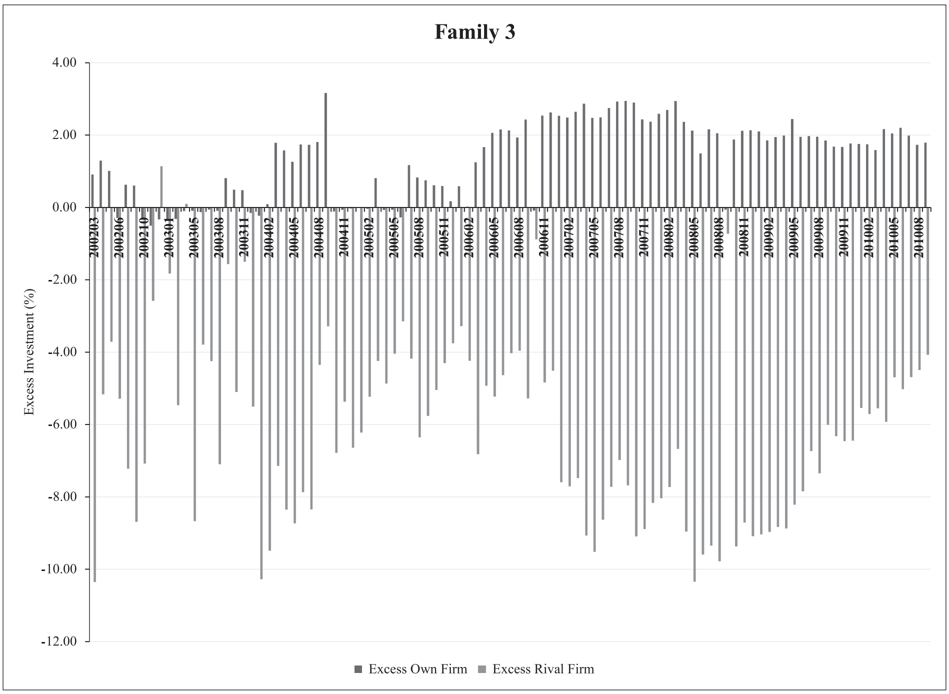
Similar variation is observed for investments in rival firms, but with a much higher size of investment (around 25% of AUM). Since the regulation restricts them to invest only in group firms, it is possible that private information is being exploited through investments in rival firms. Figure 1 illustrates the overinvestments and underinvestments in group and rival firms of two BG fund families in our sample that follow different strategies.

As expected, we find that *overinvestment in group firms leads to underperformance in BG funds*. For every 1% overinvestment of AUM in their own group firms, BG funds see a drop of 5 bps monthly or 0.6% annually in benchmark-adjusted returns. *Interestingly, underinvestment in group firms also leads to underperformance among BG funds*. The drop in benchmark-adjusted returns for BG funds is slightly higher (8 bps monthly or 0.96% annually) for every 1% underinvestment in their own group firms.

Why would funds choose to underinvest in their own firms relative to their peer funds, especially when it translates to poorer fund performance? The answer may lie in regulatory restrictions that cap a group fund's investments in all the securities (and not just stocks) of their group firms. It could be opportunistic for a fund manager to divert more funds to the debt securities of its group firms and to provide direct funding rather than to indirectly invest in its stocks. Anecdotal evidence seems to indicate that this behavior is reasonably prevalent in the Indian mutual fund industry. We are currently working to obtain data on debt investments to answer this question.

Figure 1: Overinvestments and underinvestments in group and rival firms of two BG fund families





We find similar evidence for a BG fund's investments in industry rivals of its own BG firms. Though there is a strong positive association between the fund's returns and its investment in rival firms, it is mostly driven by the relationship between underinvestment and underperformance. A BG fund underperforms to the tune of 2 basis points monthly (or 0.25% annually) on a benchmark-adjusted basis when it underinvests in its rival stocks by 1% of AUM relative to an average fund. Once again, it is puzzling to see funds choosing to underinvest only to perform badly. This could be attributed to the opportunistic motives of fund managers who may choose not to invest in rival firms for fear of antagonizing their BG parents; they would rather face the wrath of their fund investors.

4. Policy Implications

Our findings should be of interest to policymakers and regulators. The assets under management (AUM) of the Indian mutual fund industry have grown considerably since 1964, when the first fund was established. Since the first so-called mutual fund, the Unit Scheme of the Unit Trust of India, was launched in India in 1964 by an Act of Parliament (in 1963), the size of AUM of mutual funds (AUM) has grown from INR 25 crore (1 crore = 10 million) to INR 592,250 crore by March, 2011. Recent government efforts to encourage mutual fund investments, such as the Rajiv Gandhi Equity Savings Scheme (RGESS), are only likely to increase assets in the future.

However, this increase in assets is not accompanied by an increase in the universe of stocks that funds can invest in. The top 100 stocks in the NSE account for 85% of all trading activity. If we consider the fact that many of these stocks in a fund's "tradable universe" belong to a business group, it is easy to see that conflicts could arise if the funds are also owned by the same business group. The SEBI has laid down a code of conduct; those associated with mutual funds having fiduciary duties are required to follow this code of conduct. Specifically, the SEBI guidelines cap the maximum investment that a fund can invest in its group securities. Additionally, the Association of Mutual Funds in India (AMFI) has laid down a code of conduct (the AMFI Code of Ethics or ACE) for mutual fund managers. However, these restrictions do not apply to a BG fund's investment in firms that belong to the same industry in which their group firms operate.

More recently, the proposal to grant bank licenses to corporate houses is gathering steam with the government and the Reserve Bank of India; however, critics call for caution in the face of obvious conflicts of interest. Our results using the mutual fund experience suggest that sensible regulations and tight monitoring could resolve some of these conflicts.