STUDENTS' ECONOMIC FORUM

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To empower the student community...

JUNE 2007

Theme 187
MUTUAL FUND
PART-I

A monthly publication from South Indian Bank

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SIB STUDENTS' ECONOMIC FORUM

JUNE 2007

Theme No. 187 : MUTUAL FUNDS – PART I

Prelude

"Unexpected gains could disappear just as quickly as they appear. An investor has to analyze various options rather than rush to look for easier ways to make money. The key for successful investing is of 'getting in' & 'moving out' at the right time. Smart investor is one who enters the market at its bottom or at average levels and leaves the market when it gives the first sign of sinking. An investor has to focus not on speculative stocks but on those that offer real potential." Are you scared a little bit on reading the above advice given by a portfolio consultant?. If so, have a look at Mutual Funds and its advantages. This month let us have a chat on the topic – Mutual Funds.

What is a Mutual Fund?

A Mutual Fund is a pool of money, collected from investors, and is invested according to certain investment objectives. A Mutual Fund is created when investors put their money together. The most important characteristic of a Mutual Fund is that the contributors and the beneficiaries of the Fund are the same class of people, namely the investors. The term mutual means that investors contribute to the pool, and also benefit from the pool. There are no other claimants to the funds. The pool of funds is held mutually by investors in the Mutual Fund.

Describe the Structure of a MF?

Three key players namely sponsor, mutual fund trust, and asset management company (AMC) are involved in setting up a mutual fund.

Sponsor?

Sponsor means any person who acting alone or with another body corporate establishes a mutual fund. The sponsor of a fund is akin to the promoter of a company as he gets the fund registered with SEBI. The sponsor forms a trust and appoints a Board of Trustees. He also appoints an Asset Management Company as fund managers. The sponsor, either directly or acting through the Trustees, also appoints a custodian to hold the fund assets. The sponsor is required to contribute at least 40% of the capital of the asset management company.

Trust?

A mutual fund in India is constituted in the form of a public Trust created under the Indian Trusts Act, 1882. The sponsor forms the Trust and registers it with SEBI. The fund sponsor acts as the settler of the Trust, contributing to its initial capital and appoints a trustee to hold the assets of the Trust for the benefit of the unit-holders, who are the beneficiaries of the Trust. The fund then invites investors to contribute their money in the common pool, by subscribing to 'units' issued by various schemes established by the Trust as evidence of their beneficial interest in the fund.

Asset Management Company (AMC)?

The trustees appoint the Asset Management Company (AMC) with the prior approval of SEBI. The AMC is usually a private limited company formed and registered under the Companies Act, 1956, to manage the affairs of the mutual fund and operate the schemes of such mutual funds. Sponsors and their associates or joint venture partners will be the shareholders of AMC. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the Trust under the supervision and direction of the trustees. The AMC, in the name of the Trust, floats and then manages the different investment schemes as per SEBI regulations and the Trust Deed.

Can you give a live example for the structure of a mutual fund as discussed above?

In case of UTI Mutual Fund, State Bank of India, Punjab National Bank, Bank of Baroda and Life Insurance Corporation of India are the Co-sponsors. They have formed the trust UTI Trustee Co. (P) Ltd.. The joint sponsors have floated the UTI Asset Management Co. (P) Ltd., and the UTI Trustee Co. (P) Ltd. has appointed them as their Asset Management Company.

What is the business interest of sponsors and AMC and how it helps the mutual fund investors?

The AMC earns a fee for managing the funds of the investors, as per the mandate they receive from the trustees. This fee or charge is a percentage of the funds managed by the AMC. This is the income to the investors (sponsors), who have invested in the capital of AMC. With this, it is clear that the sponsor's business interest in forming mutual funds is to enhance the returns on the capital invested by them in the AMC. This is ensured by adopting strategies that enable growth, stability and confidence in the funds that the AMC manages. From this it can be

concluded that as far as the sponsors and AMCs are concerned, the interest of mutual fund investors (the public) is only secondary, but at the same time detrimental for achieving their business goals. Thus the business interest of sponsors and AMCs in mutual fund also ensures good yield to the mutual fund investors.

What are the regulatory requirements for the AMC?

In India, SEBI registered AMCs, who should have a net worth of Rs. 10 Crore can be appointed as investment managers of mutual funds. An AMC cannot be an AMC or Trustee of another mutual fund or cannot do any other business other than that of asset management. At least half of the members of the Board of an AMC have to be independent directors.

What are the benefits of investing in Mutual Funds?

1. Qualified and experienced professionals manage Mutual Funds. Generally, investors, by themselves, may have reasonable capability, but to assess a financial instrument, a professional analytical approach is required.
2. Since Mutual Funds make investments in a number of stocks, the resultant diversification reduces risk. They provide small investors with an opportunity to invest in a larger basket of variety securities.
3. The investor is spared the time and effort of tracking investments, collecting income, etc. from various issuers, etc.
4. It is possible to invest in small amounts as and when the investor has surplus funds to invest.
5. Mutual Funds are registered with SEBI. SEBI monitors the activities of Mutual Funds.
6. In case of open-ended Funds, the investment is very liquid as it can be redeemed at any time, unlike direct investment in stocks / bonds.

Are there any risks involved in investing in Mutual Funds?

Mutual Funds do not provide assured returns. Their returns are linked to their performance. They invest in shares, debentures, bonds, deposits etc… All these investments involve an element of risk. The unit value may vary depending upon the performance of the company and companies may default in payment of interest/ principal on their debentures / bonds / deposits. Besides this, the government may come up with new regulations, which may affect a particular industry or class of industries. All these factors influence the performance of Mutual Funds.

What is the difference between an Offer document and Key Information Memorandum(KIM)?

An offer document is a mutual fund's Bible. Not only does it contain every little detail about a scheme, but also the investment objective and philosophy of the fund house. It lays down the scheme's load structure, minimum investment and other such important features. Apart from this core information, the offer document also contains details regarding the structure of the Mutual Fund, how it is constituted, and the performance of existing schemes of the Mutual Fund. It also contains the procedural details about how to apply and what are the rights and obligations of the investors. The problem is that all this makes it a voluminous piece of work and people rarely have the patience to read the whole thing.

To overcome this problem, MFs and distributors have come up with the key information memorandum, or KIM. It is an abridged version of the offer document containing "key information" about the scheme, as well as an application form. In terms of sheer volume, it is easier to tackle than an offer document, and also gives you a good idea about the product. While an average offer document will be 70-80 pages thick, the KIM can manage in about eight, including the form.

Although it is undoubtedly better to read an offer document since it gives a scheme's complete picture, a KIM is a good alternative if you are pressed for time. An investor should at least go through the section in KIM titled "Investment objective". Investment objective talks about the scheme's goal and investing rationale. It specifies where the funds will be invested, in equity, debt, or both. It is important to read this section as it helps the investor to match his goals as well as risk profile with that of the scheme.

What is an Open-end fund and what makes it stay different from Close-ended fund?

An Open-end Fund is one that is available for subscription all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices, directly from the fund. This is called as an open-ended fund because, the pool of funds is open for additional sales and repurchases. A Close-ended Fund has a stipulated maturity period which generally ranges from 3 to 5 years. The fund is open for subscription only during the period of initial fund offer. Thereafter investors can buy or sell the units of the scheme in the secondary markets, where close-ended funds are listed. SEBI regulations stipulate that atleast one of the two exit options is provided to a close-ended fund investor, either an option of selling back the units to the mutual fund through periodic repurchase at NAV related prices or through listing on stock exchanges.

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- Free International ATM cum Debit Card
- Free Mobile Banking Service
- Free usage of our ATM network
- Free Any Branch Banking facilities
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- Free Depository account opening
- Free for life International Credit Card
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MUTUAL FUND INVESTMENT OPTIONS

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