MUTUAL FUNDS

What Is a Mutual Fund?

A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments, and other assets. Mutual funds are operated by professional money managers, who allocate the fund's assets and attempt to produce capital gains or income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

Mutual funds give small or individual investors access to professionally managed portfolios of equities, bonds, and other securities. Each shareholder, therefore, participates proportionally in the gains or losses of the fund. Mutual funds invest in a vast number of securities, and performance is usually tracked as the change in the total market cap of the fund—derived by the aggregating performance of the underlying investments.

KEY TAKEAWAYS

- A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities.
- Mutual funds give small or individual investors access to diversified, professionally managed portfolios at a low price.
- Mutual funds are divided into several kinds of categories, representing the kinds of securities they invest in, their investment objectives, and the type of returns they seek.
- Mutual funds charge annual fees (called expense ratios) and, in some cases, commissions, which can affect their overall returns.
- The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds.

Understanding Mutual Funds

Mutual funds pool money from the investing public and use that money to buy other securities, usually stocks and bonds. The value of the mutual fund company depends on the performance of the securities it decides to buy. So, when you buy a unit or share of a mutual fund, you are buying the performance of its portfolio or, more precisely, a part of the portfolio's value. Investing in a share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund shares do not give its holders any voting rights. A share of a mutual fund represents investments in many different stocks (or other securities) instead of just one holding.

That's why the price of a mutual fund share is referred to as the net asset value (NAV) per share, sometimes expressed as NAVPS. A fund's NAV is derived by dividing the total value of the securities in the portfolio by the total amount of shares outstanding. Outstanding shares are those held by all shareholders, institutional investors, and company officers or insiders. Mutual fund shares can typically be purchased or redeemed as needed at the fund's current NAV, which—unlike a stock price—doesn't fluctuate during market hours, but it is settled at the end of each trading day.

The average mutual fund holds hundreds of different securities, which means mutual fund shareholders gain important diversification at a low price. Consider an investor who buys only Google stock before the company has a bad quarter. He stands to lose a great deal of value because all of his dollars are tied to one company. On the other hand, a different investor may buy shares of a mutual fund that happens to own some Google stock. When Google has a bad quarter, she loses significantly less because Google is just a small part of the fund's portfolio.

How Mutual Funds Work

A mutual fund is both an investment and an actual company. This dual nature may seem strange, but it is no different from how a share of AAPL is a representation of Apple Inc. When an investor buys Apple stock, he is buying partial ownership of the company and its assets. Similarly, a mutual fund investor is buying partial ownership of the mutual fund company and its assets. The difference is that Apple is in the business of making innovative devices and tablets, while a mutual fund company is in the business of making investments.

Investors typically earn a return from a mutual fund in three ways:

1. Income is earned from dividends on stocks and interest on bonds held in the fund's portfolio. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution. Funds often give investors a choice either to receive a check for distributions or to reinvest the earnings and get more shares.
2. If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3. If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit in the market.

If a mutual fund is construed as a virtual company, its CEO is the fund manager, sometimes called its investment adviser. The fund manager is hired by a board of directors and is legally obligated to work in the best interest of mutual fund shareholders. Most fund managers are also owners of the fund. There are very few other employees in a mutual fund company. The investment adviser or fund manager may employ some analysts to help pick investments or perform market research. A fund accountant is kept on staff to calculate the fund's NAV, the daily value of the portfolio that determines if share prices go up or down. Mutual funds need to have a compliance officer or two, and probably an attorney, to keep up with government regulations.

Most mutual funds are part of a much larger investment company; the biggest have hundreds of separate mutual funds. Some of these fund companies are names familiar to the general public, such as Fidelity Investments, The Vanguard Group, T. Rowe Price, and Oppenheimer Funds.

Types of Mutual Funds

Mutual funds are divided into several kinds of categories, representing the kinds of securities they have targeted for their portfolios and the type of returns they seek. There is a fund for nearly every type of investor or investment approach. Other common types of mutual funds include money market funds, sector funds, alternative funds, smart-beta funds, target-date funds, and even funds-of-funds, or mutual funds that buy shares of other mutual funds.

Equity Funds

The largest category is that of equity or stock funds. As the name implies, this sort of fund invests principally in stocks. Within this group are various subcategories. Some equity funds are named for the size of the companies they invest in: small-, mid-, or large-cap. Others are named by their investment approach: aggressive growth, income-oriented, value, and others. Equity funds are also categorized by whether they invest in domestic (U.S.) stocks or foreign equities. There are so many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below.

The idea here is to classify funds based on both the size of the companies invested in (their market caps) and the growth prospects of the invested stocks. The term value fund refers to a style of investing that looks for high-quality, low-growth companies that are out of favor with the market. These companies are characterized by low price-to-earnings (P/E) ratios, low price-to-book (P/B) ratios, and high dividend yields. Conversely, spectrums are growth funds, which look to companies that have had (and are expected to have) strong growth in earnings, sales, and cash flows. These companies typically have high P/E ratios and do not pay dividends. A compromise between strict value and growth investment is a "blend," which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

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The other dimension of the style box has to do with the size of the companies that a mutual fund invests in. Large-cap companies have high market capitalizations, with values over $5 billion. Market cap is derived by multiplying the share price by the number of shares outstanding. Large-cap stocks are typically blue chip firms that are often recognizable by name. Small-cap stocks refer to those stocks with a market cap ranging from $200 million to $2 billion. These smaller companies tend to be newer, riskier investments. Mid-cap stocks fill in the gap between small- and large-cap.

A mutual fund may blend its strategy between investment style and company size. For example, a large-cap value fund would look to large-cap companies that are in strong financial shape but have recently seen their share prices fall and would be placed in the upper left quadrant of the style box (large and value). The opposite of this would be a fund that invests in startup technology companies with excellent growth prospects: small-cap growth. Such a mutual fund would reside in the bottom right quadrant (small and growth).

Fixed-Income Funds

Another big group is the fixed income category. A fixed-income mutual fund focuses on investments that pay a set rate of return, such as government bonds, corporate bonds, or other debt instruments. The idea is that the fund portfolio generates interest income, which it then passes on to the shareholders.

Sometimes referred to as bond funds, these funds are often actively managed and seek to buy relatively undervalued bonds in order to sell them at a profit. These mutual funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds aren't without risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much riskier than a fund that invests in government securities. Furthermore, nearly all bond funds are subject to interest rate risk, which means that if rates go up, the value of the fund goes down.

Index Funds

Another group, which has become extremely popular in the last few years, falls under the moniker "index funds." Their investment strategy is based on the belief that it is very hard, and often expensive, to try to beat the market consistently. So, the index fund manager buys stocks that correspond with a major market index such as the S&P 500 or the Dow Jones Industrial Average (DJIA). This strategy requires less research from analysts and advisors, so there are fewer expenses to eat up returns before they are passed on to shareholders. These funds are often designed with cost-sensitive investors in mind.

Balanced Funds

Balanced funds invest in a hybrid of asset classes, whether stocks, bonds, money market instruments, or alternative investments. The objective is to reduce the risk of exposure across asset classes.This kind of fund is also known as an asset allocation fund. There are two variations of such funds designed to cater to the investors objectives.

Some funds are defined with a specific allocation strategy that is fixed, so the investor can have a predictable exposure to various asset classes. Other funds follow a strategy for dynamic allocation percentages to meet various investor objectives. This may include responding to market conditions, business cycle changes, or the changing phases of the investor's own life.

While the objectives are similar to those of a balanced fund, dynamic allocation funds do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as needed to maintain the integrity of the fund's stated strategy.

Money Market Funds

The money market consists of safe (risk-free), short-term debt instruments, mostly government Treasury bills. This is a safe place to park your money. You won't get substantial returns, but you won't have to worry about losing your principal. A typical return is a little more than the amount you would earn in a regular checking or savings account and a little less than the average certificate of deposit (CD). While money market funds invest in ultra-safe assets, during the 2008 financial crisis, some money market funds did experience losses after the share price of these funds, typically pegged at $1, fell below that level and broke the buck.

Income Funds

Income funds are named for their purpose: to provide current income on a steady basis. These funds invest primarily in government and high-quality corporate debt, holding these bonds until maturity in order to provide interest streams. While fund holdings may appreciate in value, the primary objective of these funds is to provide steady cash flow to investors. As such, the audience for these funds consists of conservative investors and retirees. Because they produce regular income, tax-conscious investors may want to avoid these funds.

International/Global Funds

An international fund (or foreign fund) invests only in assets located outside your home country. Global funds, meanwhile, can invest anywhere around the world, including within your home country. It's tough to classify these funds as either riskier or safer than domestic investments, but they have tended to be more volatile and have unique country and political risks. On the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification, since the returns in foreign countries may be uncorrelated with returns at home. Although the world's economies are becoming more interrelated, it is still likely that another economy somewhere is outperforming the economy of your home country.

Specialty Funds

This classification of mutual funds is more of an all-encompassing category that consists of funds that have proved to be popular but don't necessarily belong to the more rigid categories we've described so far. These types of mutual funds forgo broad diversification to concentrate on a certain segment of the economy or a targeted strategy. Sector funds are targeted strategy funds aimed at specific sectors of the economy, such as financial, technology, health, and so on. Sector funds can, therefore, be extremely volatile since the stocks in a given sector tend to be highly correlated with each other. There is a greater possibility for large gains, but a sector may also collapse (for example, the financial sector in 2008 and 2009).

Regional funds make it easier to focus on a specific geographic area of the world. This can mean focusing on a broader region (say Latin America) or an individual country (for example, only Brazil). An advantage of these funds is that they make it easier to buy stock in foreign countries, which can otherwise be difficult and expensive. Just like for sector funds, you have to accept the high risk of loss, which occurs if the region goes into a bad recession.

Socially-responsible funds (or ethical funds) invest only in companies that meet the criteria of certain guidelines or beliefs. For example, some socially-responsible funds do not invest in "sin" industries such as tobacco, alcoholic beverages, weapons, or nuclear power. The idea is to get competitive performance while still maintaining a healthy conscience. Other such funds invest primarily in green technology, such as solar and wind power or recycling.

Exchange Traded Funds (ETFs)

A twist on the mutual fund is the exchange traded fund (ETF). These ever more popular investment vehicles pool investments and employ strategies consistent with mutual funds, but they are structured as investment trusts that are traded on stock exchanges and have the added benefits of the features of stocks. For example, ETFs can be bought and sold at any point throughout the trading day. ETFs can also be sold short or purchased on margin. ETFs also typically carry lower fees than the equivalent mutual fund. Many ETFs also benefit from active options markets, where investors can hedge or leverage their positions. ETFs also enjoy tax advantages from mutual funds. The popularity of ETFs speaks to their versatility and convenience.

Mutual Fund Fees

A mutual fund will classify expenses into either annual operating fees or shareholder fees. Annual fund operating fees are an annual percentage of the funds under management, usually ranging from 1–3%. Annual operating fees are collectively known as the expense ratio. A fund's expense ratio is the summation of the advisory or management fee and its administrative costs.

Shareholder fees, which come in the form of sales charges, commissions, and redemption fees, are paid directly by investors when purchasing or selling the funds. Sales charges or commissions are known as "the load" of a mutual fund. When a mutual fund has a front-end load, fees are assessed when shares are purchased. For a back-end load, mutual fund fees are assessed when an investor sells his shares.

Sometimes, however, an investment company offers a no-load mutual fund, which doesn't carry any commission or sales charge. These funds are distributed directly by an investment company, rather than through a secondary party.

Some funds also charge fees and penalties for early withdrawals or selling the holding before a specific time has elapsed. Also, the rise of exchange-traded funds, which have much lower fees thanks to their passive management structure, have been giving mutual funds considerable competition for investors' dollars. Articles from financial media outlets regarding how fund expense ratios and loads can eat into rates of return have also stirred negative feelings about mutual funds.

Advantages of Mutual Funds

There are a variety of reasons that mutual funds have been the retail investor's vehicle of choice for decades. The overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds. Multiple mergers have equated to mutual funds over time.

Diversification

Diversification, or the mixing of investments and assets within a portfolio to reduce risk, is one of the advantages of investing in mutual funds. Experts advocate diversification as a way of enhancing a portfolio's returns, while reducing its risk. Buying individual company stocks and offsetting them with industrial sector stocks, for example, offers some diversification. However, a truly diversified portfolio has securities with different capitalizations and industries and bonds with varying maturities and issuers. Buying a mutual fund can achieve diversification cheaper and faster than by buying individual securities. Large mutual funds typically own hundreds of different stocks in many different industries. It wouldn't be practical for an investor to build this kind of a portfolio with a small amount of money.

Easy Access

Trading on the major stock exchanges, mutual funds can be bought and sold with relative ease, making them highly liquid investments. Also, when it comes to certain types of assets, like foreign equities or exotic commodities, mutual funds are often the most feasible way—in fact, sometimes the only way—for individual investors to participate.

Economies of Scale

Mutual funds also provide economies of scale. Buying one spares the investor of the numerous commission charges needed to create a diversified portfolio. Buying only one security at a time leads to large transaction fees, which will eat up a good chunk of the investment. Also, the $100 to $200 an individual investor might be able to afford is usually not enough to buy a round lot of the stock, but it will purchase many mutual fund shares. The smaller denominations of mutual funds allow investors to take advantage of dollar cost averaging.

Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions. Moreover, a mutual fund, since it pools money from many smaller investors, can invest in certain assets or take larger positions than a smaller investor could. For example, the fund may have access to IPO placements or certain structured products only available to institutional investors.

Professional Management

A primary advantage of mutual funds is not having to pick stocks and manage investments. Instead, a professional investment manager takes care of all of this using careful research and skillful trading. Investors purchase funds because they often do not have the time or the expertise to manage their own portfolios, or they don't have access to the same kind of information that a professional fund has. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments. Most private, non-institutional money managers deal only with high-net-worth individuals—people with at least six figures to invest. However, mutual funds, as noted above, require much lower investment minimums. So, these funds provide a low-cost way for individual investors to experience and hopefully benefit from professional money management.

Variety and Freedom of Choice
Investors have the freedom to research and select from managers with a variety of styles and management goals. For instance, a fund manager may focus on value investing, growth investing, developed markets, emerging markets, income, or macroeconomic investing, among many other styles. One manager may also oversee funds that employ several different styles. This variety allows investors to gain exposure to not only stocks and bonds but also commodities, foreign assets, and real estate through specialized mutual funds. Some mutual funds are even structured to profit from a falling market (known as bear funds). Mutual funds provide opportunities for foreign and domestic investment that may not otherwise be directly accessible to ordinary investors.

Transparency
Mutual funds are subject to industry regulation that ensures accountability and fairness to investors.

Pros

- Liquidity
- Diversification
- Minimal investment requirements
- Professional management
- Variety of offerings

Cons

- High fees, commissions, and other expenses
- Large cash presence in portfolios
- No FDIC coverage
- Difficulty in comparing funds
- Lack of transparency in holdings

Too Many Mutual Funds?

Disadvantages of Mutual Funds

Liquidity, diversification, and professional management all make mutual funds attractive options for younger, novice, and other individual investors who don't want to actively manage their money. However, no asset is perfect, and mutual funds have drawbacks too.

Fluctuating Returns

Like many other investments without a guaranteed return, there is always the possibility that the value of your mutual fund will depreciate. Equity mutual funds experience price fluctuations, along with the stocks that make up the fund. The Federal Deposit Insurance Corporation (FDIC) does not back up mutual fund investments, and there is no guarantee of performance with any fund. Of course, almost every investment carries risk. It is especially important for investors in money market funds to know that, unlike their bank counterparts, these will not be insured by the FDIC.

Cash Drag

Mutual funds pool money from thousands of investors, so every day people are putting money into the fund as well as withdrawing it. To maintain the capacity to accommodate withdrawals, funds typically have to keep a large portion of their portfolios in cash. Having ample cash is excellent for liquidity, but money that is sitting around as cash and not working for you is not very advantageous. Mutual funds require a significant amount of their portfolios to be held in cash in order to satisfy share redemptions each day. To maintain liquidity and the capacity to accommodate withdrawals, funds typically have to keep a larger portion of their portfolio as cash than a typical investor might. Because cash earns no return, it is often referred to as a "cash drag."

High Costs

Mutual funds provide investors with professional management, but it comes at a cost—those expense ratios mentioned earlier. These fees reduce the fund's overall payout, and they're assessed to mutual fund investors regardless of the performance of the fund. As you can imagine, in years when the fund doesn't make money, these fees only magnify losses. Creating, distributing, and running a mutual fund is an expensive undertaking. Everything from the portfolio manager's salary to the investors' quarterly statements cost money. Those expenses are passed on to the investors. Since fees vary widely from fund to fund, failing to pay attention to the fees can have negative long-term consequences. Actively managed funds incur transaction costs that accumulate over each year. Remember, every dollar spent on fees is a dollar that is not invested to grow over time.

"Diworsification" and Dilution

"Diworsification"—a play on words—is an investment or portfolio strategy that implies too much complexity can lead to worse results. Many mutual fund investors tend to overcomplicate matters. That is, they acquire too many funds that are highly related and, as a result, don't get the risk-reducing benefits of diversification. These investors may have made their portfolio more exposed. At the other extreme, just because you own mutual funds doesn't mean you are automatically diversified. For example, a fund that invests only in a particular industry sector or region is still relatively risky.

In other words, it's possible to have poor returns due to too much diversification. Because mutual funds can have small holdings in many different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund growing too big. When new money pours into funds that have had strong track records, the manager often has trouble finding suitable investments for all the new capital to be put to good use.

One thing that can lead to diworsification is the fact that a fund's purpose or makeup isn't always clear. Fund advertisements can guide investors down the wrong path. The Securities and Exchange Commission (SEC) requires that funds have at least 80% of assets in the particular type of investment implied in their names. How the remaining assets are invested is up to the fund manager. However, the different categories that qualify for the required 80% of the assets may be vague and wide-ranging. A fund can, therefore, manipulate prospective investors via its title. A fund that focuses narrowly on Congolese stocks, for example, could be sold with a far-ranging title like "International High-Tech Fund."

Active Fund Management

Many investors debate whether or not the professionals are any better than you or I at picking stocks. Management is by no means infallible, and even if the fund loses money, the manager still gets paid. Actively managed funds incur higher fees, but increasingly passive index funds have gained popularity. These funds track an index such as the S&P 500 and are much less costly to hold. Actively managed funds over several time periods have failed to outperform their benchmark indices, especially after accounting for taxes and fees.

Lack of Liquidity

A mutual fund allows you to request that your shares be converted into cash at any time, however, unlike stock that trades throughout the day, many mutual fund redemptions take place only at the end of each trading day.

Taxes

When a fund manager sells a security, a capital-gains tax is triggered. Investors who are concerned about the impact of taxes need to keep those concerns in mind when investing in mutual funds. Taxes can be mitigated by investing in tax-sensitive funds or by holding non-tax sensitive mutual funds in a tax-deferred account, such as a 401(k) or IRA.

Evaluating Funds
Researching and comparing funds can be difficult. Unlike stocks, mutual funds do not offer investors the opportunity to juxtapose the price to earnings (P/E) ratio, sales growth, earnings per share (EPS), or other important data. A mutual fund's net asset value can offer some basis for comparison, but given the diversity of portfolios, comparing the proverbial apples to apples can be difficult, even among funds with similar names or stated objectives. Only index funds tracking the same markets tend to be genuinely comparable.

Example of a Mutual Fund
One of the most famous mutual funds in the investment universe is Fidelity Investments' Magellan Fund (FMAGX). Established in 1963, the fund had an investment objective of capital appreciation via investment in common stocks. The fund's glory days were between 1977 and 1990, when Peter Lynch served as its portfolio manager. Under Lynch's tenure, Magellan regularly posted 29% annual returns, almost double that of the S&P 500.

Even after Lynch left, Fidelity's performance continued strong, and assets under management (AUM) grew to nearly $110 billion in 2000, making it the largest fund in the world. By 1997, the fund had become so large that Fidelity closed it to new investors and would not reopen it until 2008.

As of April 2019, Fidelity Magellan has over $16 billion in assets and has been managed by Jeffrey Feingold since 2011, with Sammy Simnegar becoming a co-manager in Feb. 2019. The fund's performance has pretty much tracked or slightly surpassed that of the S&P 500.

Mutual funds

A mutual fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is invested in capital market instruments such as shares, debentures, and other securities. The income earned through these investments is shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost.

Investments in securities are spread across a wide cross section of industries and sectors and thereby reduce the risk. Asset Management Companies (AMCs) normally come out with a number of schemes with different investment objectives from time to time. A mutual fund is required to be registered with the Securities and Exchange Board of India (SEBI), which regulates securities markets before it can collect funds from the public.

HISTORY OF MUTUAL FUNDS:

Prof K Geert Rouwenhorst in 'The Origins of Mutual Funds', states that the origin of pooled investing concept dates back to the late 1700s in Europe, when "a Dutch merchant and broker invited subscriptions from investors to form a trust to provide an opportunity to diversify for small investors with limited means." The emergence of "investment pooling" in England in the 1800s brought the concept closer to the US shores.

The enactment of two British laws, the Joint Stock Companies Acts of 1862 and 1867, permitted investors to share in the profits of an investment enterprise and limited investor liability to the amount of investment capital devoted to the enterprise. Shortly thereafter, in 1868, the Foreign and Colonial Government Trust was formed in London.

It resembled the US fund model in basic structure, providing "the investor of moderate means the same advantages as the large capitalists by spreading the investment over a number of different stocks." More importantly, the British fund model established a direct link with the US securities markets, helping finance the development of the post-Civil War US economy.

The Scottish American Investment Trust, formed in February 1873, by fund pioneer Robert Fleming, invested in the economic potential of the US, chiefly through American railroad bonds. Many other trusts followed them, who not only targeted investment in America, but led to the introduction of the fund investing concept on the US shores in the late 1800s and the early 1900s. The first mutual or 'open-ended' fund was introduced in Boston in March 1924. The Massachusetts Investors Trust, which was formed as a common law trust, introduced important innovations to the investment company concept by establishing a simplified capital structure, continuous offering of shares, and the ability to redeem shares rather than holding them until dissolution of the fund and a set of clear investment restrictions as well as policies.

The stock market crash of 1929 and the Great Depression that followed greatly hampered the growth of pooled investments until a succession of landmark securities laws, beginning with the Securities Act, 1933 and concluded with the Investment Company Act, 1940, reinvigorated investor confidence. Renewed investor confidence and many innovations led to relatively steady growth in industry assets and number of accounts.

THE MUTUAL FUND INDUSTRY IN INDIA:

The mutual fund industry in India started in 1963 with the formation of Unit Trust of India (UTI) at the initiative of the Reserve Bank of India (RBI) and the Government of India. The objective then was to attract small investors and introduce them to market investments. Since then, the history of mutual funds in India can be broadly divided into six distinct phases.

Phase I (1964-87): Growth Of UTI:

In 1963, UTI was established by an Act of Parliament. As it was the only entity offering mutual funds in India, it had a monopoly. Operationally, UTI was set up by the Reserve Bank of India (RBI), but was later delinked from the RBI. The first scheme, and for long one of the largest launched by UTI, was Unit Scheme 1964.

Later in the 1970s and 80s, UTI started innovating and offering different schemes to suit the needs of different classes of investors. Unit Linked Insurance Plan (ULIP) was launched in 1971. The first Indian offshore fund, India Fund was launched in August 1986. In absolute terms, the investible funds corpus of UTI was about Rs 600 crores in 1984. By 1987-88, the assets under management (AUM) of UTI had grown 10 times to Rs 6,700 crores.

Phase II (1987-93): Entry of Public Sector Funds:

The year 1987 marked the entry of other public sector mutual funds. With the opening up of the economy, many public sector banks and institutions were allowed to establish mutual funds. The State Bank of India established the first non-UTI Mutual Fund, SBI Mutual Fund in November 1987. This was followed by Canbank Mutual Fund,LIC Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund, GIC Mutual Fund and PNB Mutual Fund. From 1987-88 to 1992-93, the AUM increased from Rs 6,700 crores to Rs 47,004 crores, nearly seven times. During this period, investors showed a marked interest in mutual funds, allocating a larger part of their savings to investments in the funds.

Phase III (1993-96): Emergence of Private Funds:

A new era in the mutual fund industry began in 1993 with the permission granted for the entry of private sector funds. This gave the Indian investors a broader choice of 'fund families' and increasing competition to the existing public sector funds. Quite significantly foreign fund management companies were also allowed to operate mutual funds, most of them coming into India through their joint ventures with Indian promoters.

The private funds have brought in with them latest product innovations, investment management techniques and investor-servicing technologies. During the year 1993-94, five private sector fund houses launched their schemes followed by six others in 1994-95.

Phase IV (1996-99): Growth And SEBI Regulation:

Since 1996, the mutual fund industry scaled newer heights in terms of mobilization of funds and number of players. Deregulation and liberalization of the Indian economy had introduced competition and provided impetus to the growth of the industry.

A comprehensive set of regulations for all mutual funds operating in India was introduced with SEBI (Mutual Fund) Regulations, 1996. These regulations set uniform standards for all funds. Erstwhile UTI voluntarily adopted SEBI guidelines for its new schemes. Similarly, the budget of the Union government in 1999 took a big step in exempting all mutual fund dividends from income tax in the hands of the investors. During this phase, both SEBI and Association of Mutual Funds of India (AMFI) launched Investor Awareness Programme aimed at educating the investors about investing through MFs.

Phase V (1999-2004): Emergence of a Large and Uniform Industry:

The year 1999 marked the beginning of a new phase in the history of the mutual fund industry in India, a phase of significant growth in terms of both amount mobilized from investors and assets under management. In February 2003, the UTI Act was repealed. UTI no longer has a special legal status as a trust established by an act of Parliament. Instead it has adopted the same structure as any other fund in India - a trust and an AMC.

UTI Mutual Fund is the present name of the erstwhile Unit Trust of India (UTI). While UTI functioned under a separate law of the Indian Parliament earlier, UTI Mutual Fund is now under the SEBI's (Mutual Funds) Regulations, 1996 like all other mutual funds in India.

The emergence of a uniform industry with the same structure, operations and regulations make it easier for distributors and investors to deal with any fund house. Between 1999 and 2005 the size of the industry has doubled in terms of AUM which have gone from above Rs 68,000 crores to over Rs 1,50,000 crores.

Phase VI (From 2004 Onwards): Consolidation and Growth:

The industry has lately witnessed a spate of mergers and acquisitions, most recent ones being the acquisition of schemes of Allianz Mutual Fund by Birla Sun Life, PNB Mutual Fund by Principal, among others. At the same time, more international players continue to enter India including Fidelity, one of the largest funds in the world.

ADVANTAGES OF MUTUAL FUNDS:

Mutual fund investments in stocks, bonds and other instruments require considerable expertise and constant supervision, to allow an investor to take the right decisions. Small investors usually do not have the necessary expertise and time to undertake any study that can facilitate informed decisions. While this is the predominant reason for the popularity of mutual funds, there are many other benefits that make mutual funds appealing.

Diversification Benefits:

Diversified investment improves the risk return profile of the portfolio. Optimal diversification has limitations due to low liquidity among small investors. The large corpus of a mutual fund as compared to individual investments makes optimal diversification possible. Due to the pooling of capital, individual investors can derive benefits of diversification.

Low Transaction Costs:

Mutual fund transactions are generally very large. These large volumes attract lower brokerage commissions and other costs as compared to smaller volumes of the transactions that individual investors enter into. The brokers quote a lower rate of commission due to two reasons. The first is competition for the institutional investors business. The second reason is that the overhead cost of executing a trade does not differ much for large and small orders. Hence for a large order these costs spread over a large volume enabling the broker to quote a lower commission rate.

Availability of Various Schemes:

There are four basic types of mutual funds: equity, bond, hybrid and money market. Equity funds concentrate their investments in stocks. Similarly bond funds primarily invest in bonds and other securities. Equity, bond and hybrid funds are called long-term funds. Money market funds are referred to as short-term funds because they invest in securities that generally mature in about one year or less. Mutual funds generally offer a number of schemes to suit the requirement of the investors.

Professional Management:

Management of a portfolio involves continuous monitoring of various securities and innumerable economic variables that may affect a portfolio's performance. This requires a lot of time and effort on part of the investors along with in-depth knowledge of the functioning of the financial markets. Mutual funds are managed by fund managers generally with knowledge and experience whose time is solely devoted to tracking and updating the portfolio. Thus investment in a mutual fund not only saves time and effort for the investor but is also likely to produce better results.

Liquidity:

Liquidating a portfolio is not always easy. There may not be a liquid market for all securities held. In case only a part of the portfolio is required to be liquidated, it may not be possible to see all the securities forming a part of the portfolio in the same proportion as they are represented in the portfolio; investing in mutual funds can solve these problems. A fund house generally stands ready to buy and sell its units on a regular basis. Thus it is easier to liquidate holdings in a Mutual Fund as compared to direct investment in securities.

Returns:

In India dividend received by investors is tax-free. This enhances the yield on mutual funds marginally as compared to income from other investment options. Also in case of long-term capital gains, the investor benefits from indexation and lower capital gain tax.

Flexibility:

Features of a MF scheme such as regular investment plan, regular withdrawal plans and dividend reinvestment plan allows investors to systematically invest or withdraw funds according to the needs and convenience.

Well Regulated:

All mutual funds are registered with SEBI and they function within the provisions of strict regulations designed to protect the interest of investors. The SEBI regularly monitors the operations of an AMC.

STRUCTURE OF MUTUAL FUNDS IN INDIA:

In India, the mutual fund industry is highly regulated with a view to imparting operational transparency and protecting the investor's interest. The structure of a mutual fund is determined by SEBI regulations. These regulations require a fund to be established in the form of a trust under the Indian Trust Act, 1882. A mutual fund is typically externally managed. It is now an operating company with employees in the traditional sense.

Instead, a fund relies upon third parties that are either affiliated organizations or independent contractors to carry out its business activities such as investing in securities. A mutual fund operates through a four-tier structure. The four parties that are required to be involved are a sponsor, Board of Trustees, an asset management company and a custodian.

Sponsor: A sponsor is a body corporate who establishes a mutual fund. It may be one person acting alone or together with another corporate body. Additionally, the sponsor is expected to contribute at least 40% to the net worth of the AMC. However, if any person holds 40% or more of the net worth of an AMC, he shall be deemed to be a sponsor and will be required to fulfill the eligibility criteria specified in the mutual fund regulation.

Board Of Trustees: A mutual fund house must have an independent Board of Trustees, where two-thirds of the trustees are independent persons who are not associated with the sponsor in any manner. The Board of Trustees of the trustee company holds the property of the mutual fund in trust for the benefit of the unit-holders. They are responsible for protecting the unit-holder's interest.

Asset Management Company: The role of an AMC is highly significant in the mutual fund operation. They are the fund managers i.e. they invest investors' money in various securities (equity, debt and money market instruments) after proper research of market conditions and the financial performance of individual companies and specific securities in the effort to meet or beat average market return and analysis. They also look after the administrative functions of a mutual fund for which they charge management fee.

Custodian: The mutual fund is required by law to protect their portfolio securities by placing them with a custodian. Nearly all mutual funds use qualified bank custodians. Only a registered custodian under the SEBI regulation can act as a custodian to a mutual fund.

Over the years, with the involvement of the RBI and SEBI, the mutual fund industry has evolved in a big way giving investors an opportunity to make the most of this investment avenue. With a proper structure in place, the industry has been able to cater to more number of investors. With the increase in awareness about mutual funds several new players have joined the bandwagon.