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Mechanism, Structure and Functions of Mutual Fund

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Abstract: *A mutual fund is a type of professionally managed collective investment vehicle that pools money from many investors to purchase securities.A mutual fund is a professionally managed type of collective investment scheme that pools money from many investors and invests it in stocks, bonds, short-term money market instruments and other securities. The income earned through these investments, and the capital appreciation realized, are shared by its unit holders in proportion to the number of units owned by them. Mutual Funds in India follow a 3-tier structure namely Sponsor, Trustees, Asset management company. We explore the issue of Portfolio very carefully and analysingdifferent types mutual funds.*

KeyWords*: Portfolio, Mutual Funds, Sponsor, Trustees.*

I. INTRODUCTION

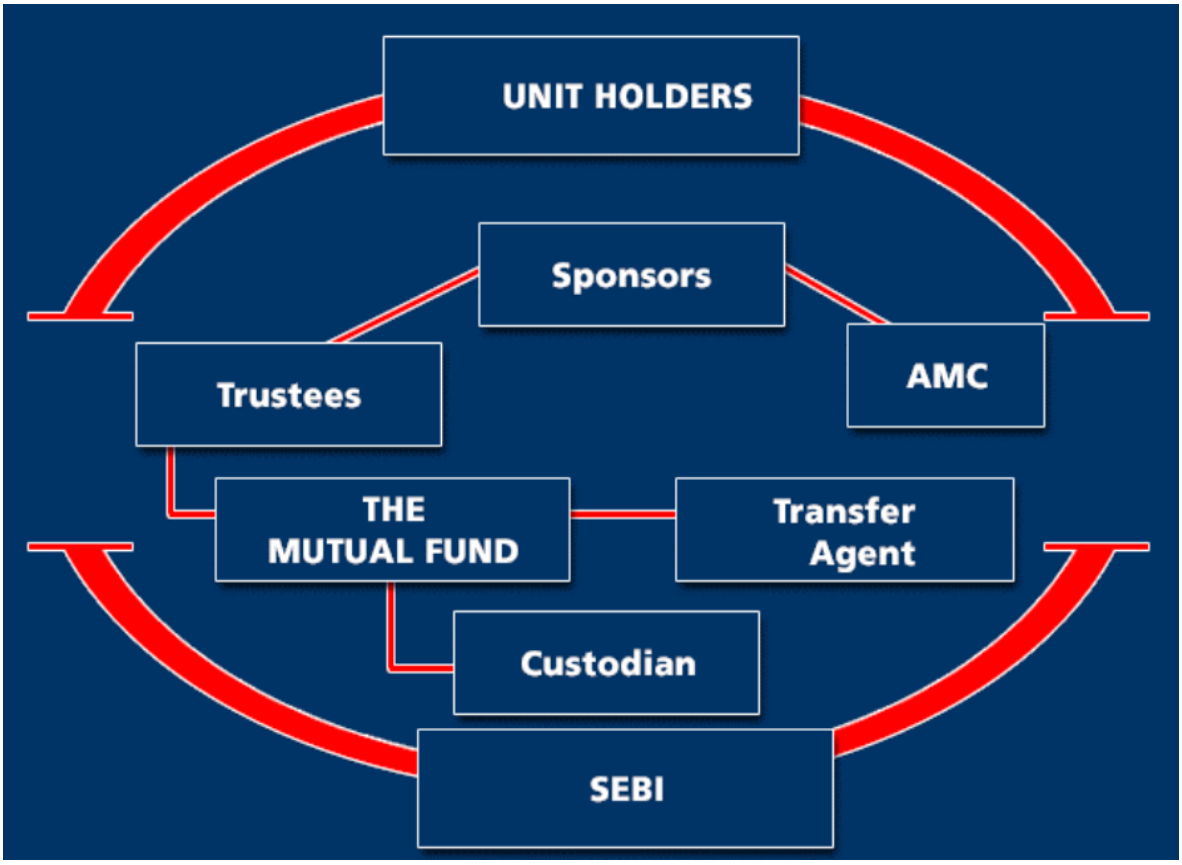
A mutual fund is nothing more than a collection of stocks and/or bonds. You can think of a mutual fund as a company that brings together a group of people and invests their money in stocks, bonds, and other securities. Each investor owns shares, which represent a portion of the holdings of the fund.You can make money from a mutual fund in three ways:1. Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution. 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.

Mutual funds have a fund manager who invests the money on behalf of the investors by buying / selling stocks, bonds etc. Currently, the worldwide value of all mutual funds totals more than $US 26 trillion. There are various investment avenues available to an investor such as real estate, bank deposits, post office deposits, shares, debentures, bonds etc. A mutual fund is one more type of investment avenue available to investors. There are many reasons why investors prefer mutual funds. Buying shares directly from the market is one way of investing. But this requires spending time to find out the performance of the company whose share is being purchased, understanding the future business prospects of the company, finding out the track record of the promoters and the dividend, bonus issue history of the company etc. An informed investor needs to do research before investing. However, many investors find it cumbersome and time consuming to pore over so much of information, get access to so much of details before investing in the shares. Investors therefore prefer the mutual fund route. They invest in a mutual fund scheme which in turn takes the responsibility of investing in stocks and shares after due analysis and research. The investor need not bother with researching hundreds of stocks. It leaves it to the mutual fund and it's professional fund management team. Another reason why investors prefer mutual funds is because mutual funds offer diversification. An investor's money is invested by the mutual fund in a variety of shares, bonds and other securities thus diversifying the investor's portfolio across different companies and sectors. This diversification helps in reducing the overall risk of the portfolio. It is also less expensive to invest in a mutual fund since the minimum investment amount in mutual fund units is fairly low (Rs. 500 or so). With Rs. 500 an investor may be able to buy only a few stocks and not get the desired diversification. These are some of the reasons why mutual funds have gained in popularity over the years.

All these developments will lead to far more participation by the retail investor and ample of job opportunities for young Indians in the mutual fund industry. This module is designed to meet the requirements of both the investor as well as the industry professionals, mainly those proposing to enter the mutual fund industry and therefore require a foundation in the subject. Investors need to understand the nuances of mutual funds, the workings of various schemes before they invest, since their money is being invested in risky assets like stocks/ bonds (bonds also carry risk). The language of the module is kept simple and the explanation is peppered with 'concept clarifiers' and examples.

II. MUTUAL FUNDS : STRUCTURE IN INDIA



Mutual Funds in India follow a 3-tier structure. There is a ***SPONSOR*** (the First tier), who thinks of starting a mutual fund. The Sponsor approaches the Securities & Exchange Board of India (SEBI), which is the market regulator and also the regulator for mutual funds.

Not everyone can start a mutual fund. SEBI checks whether the person is of integrity, whether he has enough experience in the financial sector, his net worth etc. Once SEBI is convinced, the sponsor creates a ***PUBLIC TRUST*** (the Second tier) as per the Indian Trusts Act, 1882. Trusts have no legal identity in India and cannot enter into contracts, hence the Trustees are the people authorized to act on behalf of the Trust. Contracts are entered into in the name of the Trustees. Once the Trust is created, it is registered with SEBI after which this trust is known as the mutual fund. It is important to understand the difference between the Sponsor and the Trust. They are two separate entities. Sponsor is not the Trust; i.e. Sponsor is not the Mutual Fund. It is the Trust which is the Mutual Fund. The Trustees role is not to manage the money. Their job is only to see, whether the money is being managed as per stated objectives. Trustees may be seen as the internal regulators of a mutual fund.

This is the role of the ***ASSET MANAGEMENT COMPANY*** (the Third tier). Trustees appoint the Asset Management Company (AMC), to manage investor's money. The AMC in return charges a fee for the services provided and this fee is borne by the investors as it is deducted from the money collected from them. The AMC's Board of Directors must have at least 50% of Directors who are independent directors. The AMC has to be approved by SEBI. The AMC functions under the supervision of it's Board of Directors, and also under the direction of the Trustees and SEBI. It is the AMC, which in the name of the Trust, floats new schemes and manage these schemes by buying and selling securities. In order to do this the AMC needs to follow all rules and regulations prescribed by SEBI and as per the Investment Management Agreement it signs with the Trustees.

2.1 SPONSOR

2.1.1 THE FUND SPONSOR

SEBI regulations define Sponsor as any person who either itself or in association with another body corporate establishes a mutual fund. Sponsor sets up a mutual fund to earn money by doing fund management through its subsidiary company which acts as Investment manager of the fund. Largely, a sponsor can be compared with a promoter of a company. Sponsors activities include setting up a Public Trust under Indian Trust Act, 1882 (the mutual fund), appointing trustees to manage the trust with the approval of SEBI, creating an Asset Management Company under Companies Act, 1956 (the Investment Manager) and getting the trust registered with SEBI.

2.1.2 ELIGIBILITY OF SPONSOR

Mutual funds involve managing retail investor's money and hence, it becomes important to ensure that it is run by entities with capabilities and professional merits. SEBI (Mutual fund) Regulations, 1996 specifies the following eligibility criteria in this regard: (i) Sponsor is required to have financial services business experience of at least 5 years and a positive Net worth in all the preceding five years. (ii) Sponsors' Net worth in the immediately preceding year is required to be more than the capital contribution to AMC. (iii) Sponsor is required to be profit making in at least three out of the last five years including the last year. (iv)Sponsor must contribute at least 40% of the Net worth of the Asset Management Company. Any entity, which contributes at least 40% to the Net worth of an AMC, is deemed sponsor and therefore is required to fulfil all the requirements given in 1 to 4.

2.2 TRUSTEES

The trust is created through a document called the trust deed which is executed by the fund sponsor in favour of the trustees. Trustees manage the trust and are responsible to the investors in the mutual funds. They are the primary guardians of the unit-holders funds and assets. Trustees can be formed in either of the following two ways -Board of Trustees, or a Trustee Company. The provisions of Indian Trust Act, 1882, govern board of trustees or the Trustee Company. A trustee company is also subject to provisions of Companies Act, 1956.

2.2.1 OBLIGATIONS OF TRUSTEES

Trustees ensure that the activities of the mutual fund are in accordance with SEBI (mutual fund) regulations, 1996. They check that the AMC has proper systems and procedures in place. Trustees also make sure that all the other fund constituents are appointed and that proper due diligence is exercised by the AMC in the appointment of constituents and business associates. All schemes floated by the AMC have to be approved by the trustees. Trustees review and ensure that the net worth of the AMC is as per the regulatory norms. They furnish to SEBI, on a half-yearly basis, a report on the activities of AMC.

2.2.2 REGULATION REGARDING

III. APPOINTMENT OF TRUSTEES

Sponsor with prior approval of SEBI appoints trustees. There should be at least four members in the board of trustees with at least 2/3rd independent. A trustee of one mutual fund cannot be trustee of another mutual fund, unless he is an independent trustee in both cases and has the approval of both the boards. The trustees are appointed by executing and registering a trust deed under the provisions of Indian registration Act. This trust deed is also registered with SEBI.

2.2.3 RESPONSIBILITIES OF TRUSTEES

The Trustees are required to fulfil several duties and obligations in accordance with SEBI (Mutual Funds) Regulations, 1996 and the Trust Deed constituting the Mutual Fund. These include 1.The Trustee and the Asset Management Company enter into an Investment Management Agreement (IMA) with the approval from SEBI. 2.The Investment Management Agreement shall contain such clauses as are mentioned in the Fourth Schedule of the SEBI (MFs) Regulations, 1996 and other such clauses as are necessary for making investments. 3.The Trustees shall have a right to obtain from the Asset Management Company such information as is considered necessary by the Trustees. 4.The Trustee shall ensure before the launch of any scheme that the Asset Management Company possesses/has done the following:

a. Systems in place for its back office, dealing room and accounting; b. Appointed all key personnel including fund manager(s) for the Scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market to SEBI, within 15 days of their appointment; c. Appointed Auditors to audit its accounts; d. Appointed a Compliance Officer to comply with regulatory requirement and to redress investor grievances; e. Appointed Registrars and laid down parameters for their supervision; f. Prepared a compliance manual and designed internal control mechanisms including internal audit systems; and g. Specified norms for empanelment of brokers and marketing agents.

2.3 ASSET MANAGEMENT COMPANY

The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the "Investment Manager" of the trust (Mutual Fund) via an agreement called as 'Investment Management Agreement'. An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to the regulations of SEBI too.

2.3.1 ROLE OF AMC

The AMC is an operational arm of the mutual fund .AMC is responsible for all carrying out all functions related to management of the assets of the trust. The AMC structures various schemes, launches the scheme and mobilizes initial amount, manages the funds and give services to the investors .In fact, AMC is the first major constituent appointed .Later on AMC solicits the services of other constituents like Registrar, Bankers, Brokers, Auditors, Lawyers etc. and works in close co-ordination with them.

2.3.2 RESTRICTIONS ON BUSINESS

IV. ACTIVITIES OF THE ASSET MANAGEMENT COMPANY

In India, regulator has ensured that an AMC focuses just on its core business and that the activities of AMC's are not in conflict of each other. These are ensured through the following restrictions on the business activities of an AMC. a. An AMC shall not undertake any business activity except in the nature of portfolio management services, management and advisory services to offshore funds etc., provided these activities are not in conflict with the activities of the mutual fund. b. An AMC cannot invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document c. An AMC shall not act as a trustee of any mutual fund.

2.3.3 CUSTODIAN

Though the securities are bought and held in the name of trustees, they are not kept with them. The responsibility of safe keeping the securities is on the custodian.Custodians keep the investment account of the mutual fund.

2.3.4 RESPONSIBILITY OF CUSTODIAN

Following are the responsibilities of a custodian: (i) Provide post-trading and custodial services to the Mutual Fund; (ii) Keep securities and other instruments belonging to the Scheme in safe custody; (iii) Ensure smooth inflow/outflow of securities and such other instruments as and when necessary, in the best interests of the unit holders; (iv) Ensure that the benefits due to the holdings of the Mutual Fund are recovered; and (v) Be responsible for loss of or damage to the securities due to negligence on its part or on the part of its approved agents. The Custodian normally charge portfolio fee, transaction fee and out-of -pocket expenses in accordance with the terms of the Custody Agreement and as per any modification made thereof from time to time.

V. THE INVESTOR'S RIGHTS AND OBLIGATIONS

Investors are mutual, beneficial and proportional owners of the scheme's assets. The investments are held by the trust in fiduciary capacity (The fiduciary duty is a legal relationship of confidence or trust between two or more parties).

In case of dividend declaration, investors have a right to receive the dividend within 30 days of declaration.

On redemption request by investors, the AMC must dispatch the redemption proceeds within 10 working days of the request. In case the AMC fails to do so, it has to pay an interest @ 15%. This rate may change from time to time subject to regulations.

In case the investor fails to claim the redemption proceeds immediately, then the applicable NAV depends upon when the investor claims the redemption proceeds.

Investors can obtain relevant information from the trustees and inspect documents like trust deed, investment management agreement, annual reports, offer documents, etc. They must receive audited annual reports within 6 months from the financial year end.

Investors can wind up a scheme or even terminate the AMC if unit holders representing 75% of scheme's assets pass a resolution to that respect.

Investors have a right to be informed about changes in the fundamental attributes of a scheme. Fundamental attributes include type of scheme, investment objectives and policies and terms of issue.

Lastly, investors can approach the investor relations officer for grievance redressal. In case the investor does not get appropriate solution, he can approach the investor grievance cell of SEBI. The investor can also sue the trustees.

VI. PORTFOLIO TURNOVER

Fund managers keep churning their portfolio depending upon their outlook for the market, sector or company. This churning can be done very frequently or may be done after sufficient time gaps. There is no rule which governs this and it is the mandate of the scheme and the fund managers' outlook and style that determine the churning. However, what is important to understand is that a very high churning frequency will lead to higher trading and transaction costs, which may eat into investor returns.

Portfolio Turnover is defined as 'Lesser of Assets bought or sold/ Net Assets'. If the fund manager churns the entire portfolio twice in a single year then we would say that the Portfolio Turnover rate is 200% or that the portfolio is churned once every 6 months. Liquid funds have very high portfolio turnover due to less maturity of the paper. Once the paper matures, the fund manager has to buy another security, thus churning the portfolio.

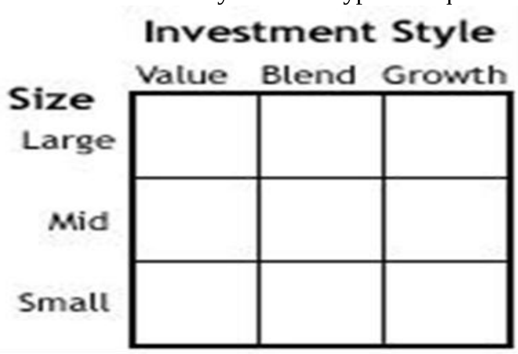
VII. TYPES OF FUNDS

Each fund has a predetermined investment objective that tailors the fund's assets, regions of investments and investment strategies. At the fundamental level, there are three varieties of mutual funds:
Equity funds (stocks)
Fixed-income funds (bonds)
Money market funds

All mutual funds are variations of these three asset classes. For example, while equity funds that invest in fast-growing companies are known as growth funds, equity funds that invest only in companies of the same sector or region are known as specialty funds.

5.1 EQUITY FUNDS

Funds that invest in stocks represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth with some income. There are, however, 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 is to classify funds based on both the size of the companies invested in and the investment style of the manager. The term value refers to a style of investing that looks for high quality companies that are out of favour with the market. These companies are characterized by low P/E and price-to-book ratios and high dividend yields. The opposite of value is growth, which refers to companies that have had (and are expected to continue to have) strong growth in earnings, sales and cash flow. A compromise between value and growth is blend, which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

5.2 BOND/INCOME FUNDS

Income funds are named appropriately: their purpose is to provide current income on a steady basis. When referring to mutual funds, the terms "fixed-income," "bond," and "income" are synonymous. These terms denote funds that invest primarily in government and corporate debt. While fund holdings may appreciate in value, the primary objective of these funds is to provide a steady cash flow to investors. As such, the audience for these funds consists of conservative investors and retirees.
Bond 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 more risky 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.

5.3 MONEY MARKET FUNDS

The money market consists of short-term debt instruments, mostly Treasury bills. This is a safe place to park your money. You won't get great returns, but you won't have to worry about losing your principal. A typical return is twice the amount you would earn in a regular checking/savings account and a little less than the average certificate of deposit (CD).

5.4 ADDITIONAL FUNDS

5.4.1 BALANCED FUNDS

The objective of these funds is to provide a balanced mixture of safety, income and capital appreciation. The strategy of balanced funds is to invest in a combination of fixed income and equities. A typical balanced fund might have a weighting of 60% equity and 40% fixed income. The weighting might also be restricted to a specified maximum or minimum for each asset class.A similar type of fund is known as an asset allocation fund. Objectives are similar to those of a balanced fund, but these kinds of funds typically 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 the economy moves through the business cycle.

5.4.2 GLOBAL/INTERNATIONAL FUNDS

An international fund (or foreign fund) invests only outside your home country. Global funds invest anywhere around the world, including your home country. It's tough to classify these funds as either riskier or safer than domestic investments. They do tend to be more volatile and have unique country and/or political risks. But, on the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification. Although the world's economies are becoming more inter-related, it is likely that another economy somewhere is outperforming the economy of your home country.

5.4.3 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 categories we've described so far. This type of mutual fund forgoes broad diversification to concentrate on a certain segment of the economy.
Sector funds are targeted at specific sectors of the economy such as financial, technology, health, etc. Sector funds are extremely volatile. There is a greater possibility of big gains, but you have to accept that your sector may tank. Regional funds make it easier to focus on a specific area of the world. This may mean focusing on a 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 is otherwise 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.

5.4.4 INDEX FUNDS

The last but certainly not the least important are index funds. This type of mutual fund replicates the performance of a broad market index such as the S&P 500 or Dow Jones Industrial Average (DJIA). An investor in an index fund figures that most managers can't beat the market. An index fund merely replicates the market return and benefits investors in the form of low fees. (For more on index funds, check out our Index Investing Tutorial.)

VIII. TAXATION

Taxation in case of Mutual Funds must be understood, primarily, from Capital Gains, Securities Transaction Tax (STT) and Dividends point of view. Tax rules differ for equity and debt schemes and also for Individuals, NRIs, OCBs and corporates. Investors also get benefit under section 80C of the Income Tax Act if they invest in a special type of equity scheme, namely, Equity Linked Savings Scheme.

IX. ADVANTAGES OF MUTUAL FUNDS

Investors may not have resources at their disposal to do detailed analysis of companies. Time is a big constraint and they may not have the expertise to read and analyse balance sheets, annual reports, research reports etc. A mutual fund does this for investors as fund managers, assisted by a team of research analysts, scan this data regularly.

Investors can enter / exit schemes anytime they want (at least in open ended schemes). They can invest in an SIP, where every month, a stipulated amount automatically goes out of their savings account into a scheme of their choice. Such hassle free arrangement is not always easy in case of direct investing in shares.
8 DIS ADVANTAGE

Professional 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.

Costs - Creating, distributing, and running a mutual fund is an expensive proposition. Everything from the manager's salary to the investors' 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. Remember, every dollar spend on fees is a dollar that has no opportunity to grow over time. (Learn how to escape these costs in Stop Paying High Mutual Fund Fees.)

8 CONCLUSION

In this paper we presented the basic concepts of mutual funds, its structures funds types and also about the taxations.We describe the idea of portfolio and we explain clearly about the investors rights and obligations.

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