Mutual Funds: The journey from 'Collective Lending' to 'Wealth Creation'

"Wide diversification is only required when investors do not understand what they are doing." - Warren Buffett

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The quote of Warren Buffett aptly fits the area of our reading. Mutual Fund is all about diversification and creation of wealth in a relatively non-complex risk – return matrix. We all are living in a financially integrated world and it would not be any exaggeration if we say that it is the global inter-flow of capital which is fuelling the growth and development of the world economy. Money is a resource, which drives up the business and growth of the economies. While money is required for the businesses to run, the investors are also always on a lookout for enhancing their returns. This creates a symbiotic relationship in which one of the entities needs funds at competitive pricing and another entity wishes to have the best returns on his/her investible surplus resources.

Augmenting Wealth: The rise of Mutual Funds

In one of the insightful writings on Mutual Funds by Sadhak H, (2003), he said that, 'The importance of financial development was amply acknowledged by classical economist (Adam Smith and others) and neo- classical economist (Alfred Marshall and others), who believed that there is a close relationship between capital accumulation and the process of economic development. However, the importance of financial factors in the development process was largely ignored and forced savings were considered the best means for financing development. But, 'the resultant financial repression is thought to be a major cause of low savings rates and the underdevelopment of the financial sector' (Hossain and Choudhury, 1996).

This phase did not last long and it was soon realised that the banking system and the non-banking financial intermediaries have the capabilities to create a supply of investment which can be far above than the "forced savings", as thought before. There have been a series of institutional changes in the last quarter of the 19th century which has also seen a subtle shift from the "only Credit" based system to a "financial" system, wherein, in addition to the banks, we have insurance, pension funds and mutual funds playing an important role in the growth and development of the economy.

Though, there is an exhaustive list of funding channels as well as investment avenues available in the market, mutual funds stand high as one of the tools which provide better side of both the instruments. As against the factors which increase the risk of investing in instruments such as capital market, bond market etc. or the relatively lower returns on low risk instruments, mutual funds provide an option of getting better returns without compromising on the risk perspective. Mutual Funds also are large subscribers of Commercial Papers (CPs) and generates returns from equity market by subscribing to public issues in primary market and by also actively playing in the secondary market. It provides the volume boost to the investment being made in the market.

The Mutual Fund Journey:

It would be imprudent to discuss about Mutual funds without analysing its origination. The investment option or the tools made available historically,

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emerged as an outcome or solutions to the politico–economic issues of that time. Mutual fund was also one of them. Another striking feature worth noting is that the roots of mutual fund lies not as an investment avenue but as a lender of what we can call now as collective lending by people to mobilise large chunk of money in the absence of any alternate source.

It is said that necessity is the mother of invention. If not completely, at least, if we trace back the financial history of the Mutual Funds, we would see that it was an outcome of a financial crisis, which hit Europe in the early 1770s. The history gets closely connected to India as at that point of time, we were also one of the colonies of the British Union. No one of us would be oblivious of the history of India. It was in the early 1600's during the reign of Mughal Emperor Jahangir that the East India Company first approached India to establish a factory. In the years going forward, the British East India Company had to resort to heavy borrowings which could fund its colonial expansion plans, beginning with North America. As with any industry, the expenses continued to increase without a matching revenue from the colonial business interests. Eventually, the company sought financial refuge with the British Treasury in 1772. However, to their ill-fate, the British treasury was already passing through period of financial stress. In the current milieu, we can relate it to a situation of a systemic important company failing in business causing a ripple effect on the business across nations and across the world.

History would let us know that the Dutch, English and the Portuguese were all traders putting all their efforts in capturing the market to generate revenues. During this period the Dutch who were very aggressive merchants, were also exploring the world across seas in search of business opportunities. While the opportunities were there, so were the challenges of business and financing.

At this crucial juncture, it was a Dutch Merchant Adriaan van Ketwich, pooled money from multiple people as subscribers to his pool and drew an Investment Trust, which later came to be known as the world's first Mutual Fund, way back in the year 1774. The key element of this pool of funds was the diversification of financial risk which was achieved by having subscribers from different countries and colonies of US etc., where the investments were backed by income from activities such as plantations.

In the same year, 1774, Abraham van Ketwich, a Dutch broker invited subscriptions from investors to form a trust named Eendragt Maakt Magt-the maxim of the Dutch Republic, "Unity Creates Strength". The fund, created by Van Ketwich's, survived only till 1824 but, the concept he created is still considered as a symbol of personal investing.

As already discussed in the beginning, the Mutual Fund journey began as a lending concept, but coming back to the present times, the first modern-day mutual fund was Massachusetts Investors Trust, which got its foundation laid down in the year 1924. Now, we have open ended and close ended schemes, however, during that period it was the first mutual fund with an open-end capitalization. In just a time span of one year, the fund catapulted itself with much force and grew from an asset size of $50,000 to a size of $392,000. The fund later became to be known as MFS Investment Management after going public in the year 1928.

Mutual Funds in India:

In India, the first mutual fund was launched in the year 1964, though it continued to move at a very slow pace until 1980s. This phase was dominated by UTI. It was in the late 1980s that non-UTI public sector mutual funds also entered the market and the first in the series was SBI Mutual Fund which was launched by SBI in November 1987. This was followed by Canbank Mutual Fund and LIC Mutual Fund and others. The final phase of the mutual fund history in India can be traced back to 1993, when the market was opened

for the private sector funds. The first of such fund was Kothari Pioneer Mutual Fund in November 1993. This was followed by ICICI, 20th Century, Morgan Stanley and Taurus Mutual funds.

The free entry of Mutual Funds exposed the Indian market to some inherent weaknesses in the Indian financial market. The loose links found during this period were tightened through several measures initiated by SEBI from 1995-96 to 1999-2000 to streamline the operations.

In India, the Mutual Fund industry is regulated by SEBI. The industry is also supported by Association of Mutual Funds in India (AMFI), which is dedicated to developing the Indian Mutual Fund Industry on professional, healthy and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit holders.

Why Mutual Funds?

Any individual with surplus funds can move around in the market and choose one of the many available investment options, which may be offering assured returns such as bank deposit or government saving schemes or variable returns in options such as stock market. In case of an enterprising risk taker, he or she can venture into the domain of segments such as futures and options or commodity trading etc. The question arises, then why Mutual Funds has emerged as one of the best available asset classes. Is it an income maximising tool; a risk optimising instrument or may be a speculative investment. What exactly is it? Let us try to unravel this mystery and understand things better from an investor's, perspective.

In case of Mutual Funds, the best premise what I understand is that of risk diversification, better portfolio allocation and the best risk-return matrix. Though, there cannot be a strict definition of Diversification, it being an investment concept, Investopedia does provide a definition, which says that Diversification is a technique that reduces risk by allocating investments among various financial instruments, industries, and other categories. It aims to maximize return by investing in different areas that would each react differently to the same event. Most investment professionals agree that, although it does not guarantee against loss, diversification is the most important component of reaching long-range financial goals while minimizing risk.

An investment is always subject to risk and return matrix. The more the expected return, more would be the risk. Though, any Investment is subject to a large variety of risk, it can be basically classified into systematic risk and unsystematic risk.

The systematic risk also called as market risk or undiversifiable risk is at the macro level and is applicable to all the companies or industries operating within a relatively common environment. It may relate to factors such as inflation, exchange rates, political instability, war, interest rates or other macro numbers. This kind of risk is not company specific or industry specific and is quite generic in nature, it cannot be managed through diversification at individual micro level. This gets managed by a combination of factors which require policy interventions at global and national levels, and so have to be as such built into the risk calculations.

The second type of risk is the unsystematic risk. This risk is associated with a specific company, industry, market, economy, or country and can, therefore, be controlled through diversification. Though there are a number of risk factors, the most common sources of unsystematic risk are business risk and financial risk. The aim of an efficient Fund Manager, therefore, should be to ensure that the investment of the pooled resources is done in such a way across various assets so that they do not get affected the same way by market events.

Why Should You Diversify:

In the financial world, the birth of Mutual Funds as an investment option was nothing less than a revolution in itself. The investing power, hitherto, being thought to be with the affluent class tricked down to the common small investor community and the people with little surplus money got an option of pooling their resources to a fund management firm, which was professionally managed and ensured that the money received from small retail investors is put in a diversified basket of investments. This was as against the expensive proposition of purchasing individual stocks carrying different risks.

We are hearing a lot on the oil prices front, so let us take the same example and assume that you have a portfolio of oil stocks only. In case of an increase in global oil prices, the downstream sector of oil and gas industry would suffer and your portfolio may suffer. However, if you would have taken other sectors of industry in your portfolio, the chances of balancing the loss with gain in others would be higher. This gets more balanced if you add retail stocks also in the bucket to further diversify. The key lies in the mix. The more unrelated and uncorrelated your stocks are, the better prospects are there for minimising the losses.

If we think one step further, it is important to diversify among different asset classes. Different assets - such as bonds and stocks - will not react in the same way to adverse events. A combination of asset classes will reduce your portfolio's sensitivity to market swings. Generally, bond and equity markets move in opposite directions, so if your portfolio is diversified across both areas, unpleasant movements in one will be offset by positive results in another.

In case of investment in mutual funds, you are not tied up with a certain stock or a group of stocks. On top of this, you are not alone and responsible for the ups and downs you face in your investment. The most conventional view argues that an investor can achieve optimal diversification with only 15 to 20 stocks spread across various industries.

Performance of MFs in India:

As on March 31, 2018, there were 45 mutual funds registered with SEBI, of which 34 were in the private sector and seven (including UTI) were in the public sector.

The number of Indians investing in capital markets has traditionally been low, and most of the people parked their funds in bank deposits. But, a study shows that mindset is slowly changing; as bank deposit rates fell, mutual funds have been able to garner a proportionately higher share of household savings.

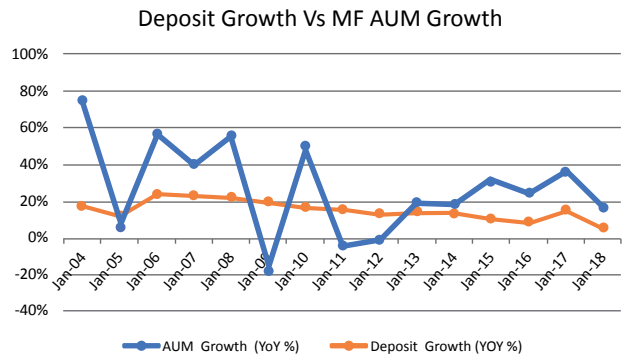
The growing potential of Mutual Funds gains resonance with SEBI mentioning in its annual report that 'buoyed by robust capital inflows and strong participation of retail investors, the asset base of the mutual fund industry again produced record breaking numbers in 2017-18. The Average Asset Under Management (AAUM) of MF industry for the year 2017-18 was ₹21.46 lakh crore. However, mutual funds AUM to GDP ratio of 12.8 per cent in 2017-18 indicates a large untapped market potential and very low penetration vis-a-vis global and peer benchmarks'.

Between 2014-15 to 2017-18, Assets Under Management (AUMs) of mutual funds doubled from ₹10.83 lakh crore to ₹ 21.36 lakh crore. (According to AMFI data, the Asset Under Management (AUM) of the industry, comprising 42 players, climbed from ₹22.23 lakh crore at the end of October, to ₹24.03 lakh crore in November-end). In comparison, bank deposits rose about 34 per cent to ₹114.26 lakh crore from ₹85.33 lakh crore in the same period. While the bank deposit pool remains significantly large, the steady increase in the share of mutual funds in total incremental savings deployed in deposits and mutual funds increased from 12.6 per cent in 2014-15 to around 19 per cent in 2017-18.

The table clearly reflects the growing influence of the mutual funds as an alternative safe investment avenue, which so far was only deposits.

Year	Mutual Fund AUM	SCBs Agg Deposit	MF as a %age of Deposit
Mar-93	0.48	2.69	17.77
Mar-03	0.79	12.81	6.25
Mar-04	1.40	15.4	9.28
Mar-05	1.50	17.00	8.80
Mar-06	2.32	21.09	10.99
Mar-07	3.26	26.12	12.50
Mar-08	5.05	31.97	15.80
Mar-09	4.17	38.34	10.88
Mar-10	6.14	44.93	13.67
Mar-11	5.92	52.08	11.37
Mar-12	5.87	59.09	9.94
Mar-13	7.01	67.50	10.39
Mar-14	8.25	77.06	10.71
Mar-15	10.83	85.33	12.69
Mar-16	13.50	93.27	14.47
Mar-17	18.29	107.58	17.00
Mar-18	21.36	114.26	18.69

If we see the growth pattern also, then we would see that the growth of AUM has been relatively higher than the deposit growth, though the variations are also on a higher side owing to the risk and volatility attached to the mutual fund investment as compared to the deposit which offer a lower but risk free return.



The increasing interest of the household investors towards mutual funds or other asset classes like this gets corroborated, when we see the movement in the household savings.

Components	2011-12	Average Eleventh Plan	2012-13	2013-14	2014-15	2015-16	2016-17	Average Twelfth Plan
Gross Savings in Financial Assest	11.1	13.7	12.4	13.8	15.0	16.1	16.4	14.7
Net House hold Financial Savings	8.0	10.4	9.0	10.0	10.8	11.6	11.9	10.7
House hold savings physical assets	14.3	13.0	13.2	12.7	12.2	11.7	11.7	12.3
House hold savings total	22.3	23.4	22.8	22.7	23.0	23.3	23.6	23.0
Savings by the private corporate sector	7.2	8.1	7.3	7.7	8.0	8.5	8.5	8.2
Savings by the public sector	1.3	2.0	1.5	2.0	2.5	3.1	3.9	2.7
Gross Domestic Savings	**30.8**	**33.5**	**31.0**	**32.4**	**33.5**	**34.9**	**36.0**	**33.6**
Finance for Investment	**35.0**	**36.1**	**35.8**	**36.2**	**36.5**	**37.7**	**38.5**	**36.9**
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The table above clearly shows that the gross savings in the financial assets have been increasing consistently and this shows the confidence of the households in financial assets.

The data indicates that the investor community is becoming comfortable with the financial markets and the mutual fund route is the best way to ensure retail participation in the equity and debt market of the country.

The economy as such is passing through a declining interest rate cycle, which may continue for some more time to assuage the credit market and provide them succour in the form of affordable lending rates. While this is also critical to support the business community in times of stress, in such a scenario, a risk averse investor looks to other risk mitigated investment avenues of which Mutual Fund emerges as the best option.

Conclusion:

The risk appetite of a common customer has been increasing over the period. The customers are looking out for better returns and are not feeling shy of making investments in slightly riskier assets. Mutual fund gives them the opportunity of choosing their returns based on the individual risk appetite of the customer. While the trend can be further firmed up after couple of years, there is another view coming out in relation to their preference within Mutual Fund as an asset class, which indicates that there has been a movement of customer to equity oriented MFs, which hitherto was focussed only on the balanced funds. One of the reports published by Care ratings says that there has been an increase in the share of growth or equity schemes with the share moving up from 24.6% to 35.1% during the period between 2012 and 2018.

As the economy is growing, the financial markets are also evolving. Rise of Mutual funds as an alternative asset class for investment returns is a sign of financial deepening. It draws a simile to the rise of other sources of credit such as external borrowing, bonds etc. other than the traditional means of bank credit.

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BANK QUEST THEMES FOR NEXT ISSUES

The themes for next issues of "Bank Quest" are identified as:

- Ethics & Corporate Governance in Banks: April - June, 2019
- Emerging technological changes in Banking: July - September, 2019